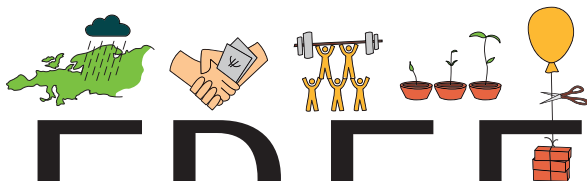


Edited by Maciej Kisilowski



# FREE MARKET IN ITS TWENTIES

**Modern Business Decision Making  
in Central and Eastern Europe**

Foreword by George Soros

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## FREE MARKET IN ITS TWENTIES





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MODERN BUSINESS DECISION MAKING  
IN CENTRAL AND EASTERN EUROPE

Edited by  
Maciej Kisilowski



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over the past 25 years.





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George Soros

## FOREWORD

**T**he story of the rise of democracy and a market economy in Central and Eastern Europe (CEE) over the past twenty-five years is often told as a series of historic events: the fall of the Berlin Wall, the collapse of the Soviet Union, the brutality of the Balkan Wars, the accession of a number of CEE states to NATO, the “color revolutions” in a number of post-Soviet countries, and the eastward enlargement of the European Union. But behind these obviously monumental events—sometimes spectacular, sometimes tragic, and often both—lies another story: that of the effort to build the fledging CEE market economies. This largely untold story is less about politicians and more about managers and entrepreneurs seizing remarkable economic opportunities that history has given them.

In my writings, I have often emphasized the reflexive relationship between thinking and reality: We create conceptual frameworks to make sense of the reality that surrounds us, but these frameworks end up affecting and distorting the reality itself. Applying this reflexive prism, we may conclude that the overwhelming focus of the CEE public discourse on macro-political narratives, and the concomitant neglect of managerial and entrepreneurial narratives, contributed to the poor record of the region in areas such as innovation and global competitiveness.

Political economy often focuses on the interplay of factors influencing large groups of people, but managerial and entrepreneurial perspectives taught at modern business schools emphasize organizational decision making and indi-

vidual agency. Successful entrepreneurs whom I know believe in their ability to find opportunities in even the most flawed and volatile environments. For them, the fall of communism represented what the economist Joseph Schumpeter called a “gale of creative destruction.”

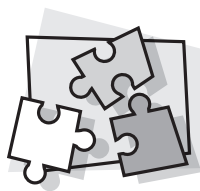
To be sure, in some circumstances this entrepreneurial drive can lead to highly undesirable social outcomes. In *The Crisis of Global Capitalism*, I discussed at length how, in Russia, the opportunistic behavior of newly minted entrepreneurs led to “robber capitalism” and a massive transfer of wealth to a narrow group of corrupt oligarchs. However, such a specific counter-productive experience should not overshadow the fundamental point that CEE needs effective professional managers and risk-taking, opportunity-seeking entrepreneurs.

Even before the fall of the Berlin Wall, I decided to do something concrete to nurture such attitudes and capabilities in the region. In 1988, with a group of like-minded businessmen, we decided to create in Budapest the International Management Center, which later came to be known as CEU Business School. Our actions attracted a great deal of interest and generated considerable excitement. Over the past twenty-five years, CEU Business School has produced a generation of management professionals who have significantly contributed to the development of the region.

Now, CEU Business School is entering its next quarter century. The landscape is quite different today, and in many ways the challenge for the School is more difficult than it was when it was founded. The region is still experiencing the aftershocks of the 2008 meltdown and the more recent euro crisis. In many CEE nations, the political situation contributes to economic instability. Economic growth is uneven and, as I mentioned earlier, the region lags in crucial indicators of innovation and competitiveness.

Both the region and CEU Business School must develop new and compelling strategies for the next twenty-five years. This faculty-authored volume highlights some of the approaches the School is taking to address key elements of that essential task.

This volume is notable for its grounded and multifaceted outlook on the current CEE business environment. It should serve to promote the crucially important discussion of the need to make this region more agile and attractive in the global economy. I am gratified by this work and the promise of CEU Business School to stimulate even greater innovation and world-class managerial education for the region and beyond.



Mel Horwitch *and* Maciej Kisilowski

Introduction:

# MANAGERS, ENTREPRENEURS, AND LEADERS IN THE EVER MORE COMPLEX CEE ENVIRONMENT

## CHAPTER IN BRIEF:

- ❏ Political-economic change in CEE requires a transformation of managerial perspectives and practice.
- ❏ CEE businesses need innovation rather than mere replication, and leadership rather than mere management.
- ❏ Today's CEE manager needs sophisticated understanding of regional trends, key global forces, and new approaches for business thinking and decision making.

**T**his book emerges from a faculty-led initiative at a business school embedded in Central and Eastern Europe (CEE) for twenty-five years. Therefore, the perspectives you will find on the pages to follow are chiefly those of managers, entrepreneurs, and leaders. Before we get there, however, we invite you to step back and examine the broader context. Setting aside for the moment current worries of our Great Recession, let's take a helicopter view at the socio-political and economic changes that have taken place in many parts of CEE over the past two decades. It is really difficult not to be impressed. Starting from a more or less brutal form of communist authoritarianism, the region has by and large created working—even if imperfect—democracies. Since the early 1990s,

in the eleven post-communist nations that are currently member states of the EU—the so-called EU11—there have been more than fifty peaceful transitions of political power due to elections. That is truly impressive if we take seriously one famous definition of democracy being “a system in which parties lose elections”<sup>1</sup> and if we keep in mind Winston Churchill’s dictum about democracy being “the worst form of government except all the others that have been tried.”

The transition to a market economy has been equally all encompassing. If we look again at the EU11 frontrunners, their average per capita GDP (adjusted for differences in purchasing power) almost tripled between 1990 and 2011. The value of foreign direct investment alone during the two post-transition decades has been more than 2.5 times higher than the total economic output of the EU11 countries in 1990. This unprecedented embracing of market economies has been also accompanied by the steady improvement of the business climate in all EU11 countries. In 2002, 45 percent of EU11 firms surveyed by the World Bank reported paying bribes to public officials; in 2009, the figure dropped to 13 percent. In 2003, the median length of the formal process for setting up a business in Central Europe was thirty-two days; in 2011 only sixteen days.<sup>2</sup> In short, the region’s post-communist nations have been given an opportunity almost unprecedented in history—the chance to join the political and economic block of some of the richest nations on earth, on the condition of rapid institutional modernization.

### **Socio-Political and Economic Complexity**

And yet there are good reasons to see the glass half-empty rather than half-full. For one thing, the socio-political and economic progress mentioned above has been very uneven. Leaving the more or less happy bunch of the EU11 countries, going farther east or south, the picture becomes bleaker. Stagnant economies, rampant corruption, and the rise of extreme nationalist movements seem to be the new norm in countries stretching from Belarus to Moldova to Serbia. Even if we get back to the EU11 block, we can still see too many examples of nationalistic and populist policies, low growth, large debt, and high unemployment. For example, the Hungarian government has been accused of hurting the country’s young democracy and market economy through a host of sweeping reforms it has undertaken since its ascent to power in 2010. Although views on the nature, implications, and true significance of specific policy measures or instances of political rhetoric obviously vary, the very fact that such a controversy has emerged with respect to a country once considered the regional leader of democratic and free market transition is worrisome.

To make matters worse, this is all taking place at a time when societies worldwide face growing difficulty in dealing with several longer-term global challenges, be they climate change, global health risks, mega cities, rapidly rising China, increasing economic inequality within and among nations, and the persistence of systemic risks in the global financial market. From this vantage point,





CEE is not particularly unique in having serious problems to confront. The very same international watchdog institutions that have leveled heavy criticism against Hungary's Orbán or Poland's Kaczyński governments had made arguably more serious allegations of political misconduct against the governments of old democracies, including that of the United States during the George W. Bush administration or Italy under the rule of Silvio Berlusconi. The increased popularity of far-right parties seems to be as much (if not more) a problem of the “Old” Europe—from Austria to France to the Netherlands to Greece—as it is of the “New” one. The multiple crises in the eurozone have in part been due to mistakes in institutional design made by politicians and bureaucrats who advised and expected the eleven post-communist candidate states to adopt a single currency.

### **Enter Managerial, Entrepreneurial, and Leadership Perspectives**

The socio-economic complexities discussed above are important, and they also provide background for other equally long-lasting, significant, and certainly more neglected developments. We refer to the diverse changes, opportunities, and challenges occurring at the managerial, entrepreneurial, and leadership levels. These largely ignored, yet pivotal, forces could well prove extremely influential and perhaps decisive in determining the CEE performance during the next decade.

The adoption and growing pervasiveness of modern and at times sophisticated management, entrepreneurship, and leadership in CEE are already impressive. All this activity is supported by a growing constellation of business schools teaching an increasing cadre of managers, entrepreneurs, and leaders and conducting research on critical challenges facing such individuals and their organizations. At CEU Business School for over twenty-five years we have inter-

acted with a wide range of professionals and leaders, including CEOs of CEE branches of multinational corporations, entrepreneurs running high-tech or family businesses, social entrepreneurs heading nongovernmental organizations, financial professionals in banks or boutiques and consultants and analysts helping clients throughout the region. However, until now, the way this rising, broadly defined managerial perspective and support structure can help turn around the region and make it competitive in the twenty-first century has gone largely unnoticed.

This book, written for a wide range of professionals and scholars, represents precisely such an attempt to examine the task of CEE revitalization from managerial, entrepreneurial, and leadership perspectives. Thanks to the visionary leadership of George Soros, the founder of our institution, CEU Business School faculty comprises a very special group of academics. This group includes scholars and practitioners who have been trained or taught at some of the world's top educational institutions; management thinkers, business leaders, economists, lawyers, and psychologists from nine countries and three continents with work experience spanning over fifty countries around the globe; and engaged citizens who for a myriad of reasons have become fascinated by this unlikely story of a historic opportunity for a civilizational leap—the story that CEE embodies.

Our perspective on the topics we tackle is broadly and creatively *managerial*. What we mean by this is that we believe macroeconomic and political trends that surround us are not rigidly fixed and our choices are not completely predetermined. Managers have some degree of freedom in building and developing successful organizations in what is emerging as a dynamically changing



Political-economic trends that surround managers are not rigidly fixed.

competitive setting with changing demographics (especially in CEE where new generations have no memory of the communist times). The region with its established firms, startups, managers, and entrepreneurs must

plan, operate, and innovate on an increasingly worldwide scale. Thus, competitive success depends on mastering new rules with both creative and systematic thinking and execution. This must happen in a diverse external context that offers an ever more varied palette of options for corporate finance, managing increasingly global supply chains, leveraging new technologies, and making sense of the multi-layered system of local, national, regional, and global regulatory regimes. These are but a few of the many tasks a modern manager needs to address.

We have come to recognize the importance of infusing CEE with *entrepreneurial* spirit. Indeed, we strive to upgrade and nurture it. In our region, “entrepreneurship” is often understood quite narrowly as a process of building a new startup company. For us, however, the term has a much broader meaning. The economist and political scientist Joseph Schumpeter defined entrepreneurs as

individuals who “reform or revolutionize the pattern of production.” That creative act of getting rid of old, time-honored habits and introducing something new is badly needed in businesses large and small; and, indeed, not only in businesses, but also in government, nongovernmental organizations, and academia. In every organization, there can reside entrepreneurs who can adapt to the rapidly changing world. Those who instead of being stuck in the past will have confidence to assume a pacesetter position for their organizations and the region as a whole. Through our teaching and research, we are constantly reminded that simply satisficing with accepted ideas is not an option for CEE. A business school like ours has long been deeply immersed in the region while at the same time is in sync with state-of-the-art management theory and practice.

Another major notion underlying this volume is that of *leadership*. We have found that our understanding of leadership in CEE must be broadened, professionalized, and integrated in new and powerful ways. In the planned economy, the division of leadership roles was formally ascribed. Today, however, leadership can occur at multiple levels with a new constellation of leaders emerging, including entrepreneurs, corporate executives, managerial professionals, nonprofit activists, and so on—all manifesting a blend of best-practice professionalism, drive, creativity, and flexibility. Sophisticated organizational leadership is important no matter where one works. Moreover, as a new generation enters the workforce, expectations regarding the standard of this leadership will only increase. For students at our business school who espouse new values of the so-called Generation Y, the relevant benchmark is not the grayish communist landscape; it is their recent trip to London, Berlin, New York City, or Dublin, where they went for a work-and-study program over the summer or as part of an MBA module. These professionals of the future expect, and indeed demand, from our business, social, and political leaders to become a part of a transition arguably much harder than the one our region completed after the fall of communism. What we mean here is the transition to a globally competitive knowledge-intensive economy; in other words, moving from the second-world normalcy to the first-world prosperity. And a big part of the challenge here is that, with the traditional first world in turmoil, the CEE nations can no longer merely replicate what has been earlier accomplished by the West. The road ahead is full of difficult tasks; even the most advanced nations do not have definite answers on how to accomplish them.

## **Part I: Best Practices and Beyond**

Of course, CEE has still much to learn from the advanced economies. There are still many areas where simply looking for and copying successful international practices would be the best way for our region to go. The chapters in Part I focus largely on these kinds of challenges. The opening preview is written by Stuart Durrant, from the perspective of a practitioner. In Chapter 1.2, György Bógel discusses the urgent need for CEE to embrace innovation as the most

important engine of growth. In Chapter 1.3, Anna Turner offers some practical advice on how CEE companies can and should broaden their palette of options for sophisticated corporate finance. Caterina Sganga takes a similar approach on the topic of intellectual property (IP) rights management in Chapter 1.4, emphasizing the glaring chasm in IP awareness between CEE and Western managers. Chapter 1.5 by Charles Mayer offers a case study of the small town of Szentendre, near Budapest, to make a larger point about the need of retailers of fast-moving consumer goods (FMCG) to take a more realistic view on the maturing CEE market. According to Mayer, gone are the days when retailers could get away with a wayward all-in approach, which defined the early days of the transition and which amounted to a combination of the bandwagon effect and the instinctive fear of the competition getting a first-mover advantage. The stage is now set for consolidation, mergers and acquisitions (M&A), and shake-out of the weaker players.

Perhaps the most somber reality check to our overall ambition of offering a managerial perspective for pushing CEE onto the path to first-world prosperity is provided by Yusaf Akbar and Vukan Vujic in Chapter 1.6. Their multi-country analysis demonstrates the persistent importance of cultural factors in determining the difference in the extent of governmental corruption between CEE and the highly developed world. As the authors themselves admit, such cultural factors are particularly difficult to change. But Akbar and Vujic still conclude with a call for action, addressed both to managers and to policy makers.

The picture drawn by Peter Hardi in his chapter demonstrates just how difficult the change that Akbar and Vujic call for may be. Using some recent examples from the region, Chapter 1.7 shows how failures of the state can often lead to a demand that these failures should be remedied by socially responsible businesses.



Moving a knowledge-based economy will be harder than the transition of 1989.

The author concludes that corporate social responsibility (CSR)—for many years considered a voluntary practice in the West, supported by soft government policies—is increasingly seen by the state in CEE as a mandatory supplement to

government social policies. Hardi posits that this tendency runs parallel with the latest changes of the European Commission's interpretation of CSR, a trend that may have important consequences on the state-firm relationship in general.

With business-government relations so often dysfunctional, one may look for hope in civil society groups. In the area of anti-corruption, it is hard to find a more established such NGO than Transparency International (TI). That is why the personal account of Noémi Alexa—a long-time CEO of the Hungarian branch of the TI and now our Business School colleague—is particularly interesting. Her message in Chapter 1.8, while not hopeless, is mixed. Even with a dedicated team and a highly entrepreneurial manager, the lack of political will

to confront corruption, which seems to transgress ideologies and party lines, is difficult to overcome.

Although the first part of the book does focus on fixing aspects of CEE's business environment that remain out of sync with global best practices, the authors try not to limit themselves to a plea for simple replication of Western standards. Bögel, for instance, discusses how moving up the innovation ladder creates complex social and political challenges even for frontrunners on that path, such as the United States. Turner places her call for diversification of the sources of corporate finance in a broader context of the credit crunch that affects many "old" market economies every bit as much as the countries in our region. Sganga is far from uncritical about the way in which the global system of intellectual property rights protection has been developing. The governmental failures that Hardi talks about do not stem from institutional limitations typical of only CEE. In Western Europe, for instance, the Great Recession created fiscal pressures that also limit the ability of governments to solve social problems even under the most efficient institutional settings.

A particularly telling piece of evidence for how our fellow authors challenge the simplistic ascription of the "follower" and the "model" roles to, respectively, CEE and the West comes from Akbar and Vujic. In discussing the formatting of their chapter, the authors firmly objected to our suggestion to refer to the region of our common interest as Central and Eastern Europe—the convention we use in every other chapter. In the authors' view, this standard expression "carries with it negative connotations—in a similar way as 'the Balkans' do, in contrast, say, to 'Southeast Europe.'"<sup>3</sup> Accordingly, their chapter refers consistently to Central and East Europe, which is a less charged designation. Whether you agree with them or not, their awareness of the relation between the way we express our thoughts and the conclusions we reach aptly represents the collective attitude of all authors of this book. We all strive to show the present and the future of the business environment in this part of the world in all its complexity, rather than offering yet another progress report on economic transition.

## **Part II: Global Trends**

The uncharted nature of the path to a highly prosperous knowledge-intensive economy becomes even more evident in the second part of the book, which discusses CEE in the context of some of the world's most important global trends. In her preview chapter, Maria Findrik emphasizes the enormous effort required to improve CEE's competitiveness in the rapidly changing world. In Chapter 2.2, Paul Marer offers rather blunt conclusions about the causes and the potential consequences of the multiple crises engulfing the eurozone. Marer highlights the list of institutional design flaws and failures of governance that have contributed and reinforced these crises. He also offers plausible scenarios of why and how the eurozone's membership could become smaller.

It is obviously no coincidence that we placed Chapter 2.3 about the role of CEE in China's international expansion right after Marer's discussion about the eurozone crises. The author (Paul Lacourbe) clearly would like to see CEE managers, entrepreneurs, and leaders to consider China to be if not an alternative to the European project, then at least a component of a more diverse strategy for positioning the region in the global economic arena. Lacourbe's ambition is for us to understand not only the economic and geopolitical objectives of modern China, but also the social and historical origins of those objectives. Put simply, Lacourbe wants you to put yourself into the shoes of China's decision makers. This is important especially for those of us who are tempted to view the communist political system of today's China through the prism of our region's own experience with the socialist system.

While Lacourbe urges CEE business leaders to firmly put the Far East on their radar screen, John Shattuck argues for the continued importance of paying attention to the "Far West." In Chapter 2.4, Shattuck has no doubts that the United States will remain a pivotal global economic and political force for decades to come and that Europe in general, and CEE in particular, should smartly leverage their transatlantic ties. Shattuck is very specific about the areas where greater U.S. engagement can be particularly beneficial from the perspective of CEE's economic development. These areas include trade policy, advocacy of stimulus measures, support of EU governance reforms, and continuous reinforcement of democratic values in the face of destabilizing nationalistic tendencies.

Important global trends are obviously not necessarily linked to the geopolitics of any specific country or region. The final four chapters of the second part of

the book tackle such "borderless" trends. In Chapter 2.5, Michael LaBelle talks about the potentially disastrous path on which the world has been staying with regard to skyrocketing carbon emissions. But unlike many other commen-



Global trends are not necessarily linked to geopolitics.

tators on the topic, LaBelle is by no means fatalistic. With his appreciation of the creative power of market forces, he offers a realistic plan for limiting and ultimately eliminating carbon emissions. It is somewhat surprising that he points to Poland—rather than some usual suspect from the West such as Germany or Sweden—as being at the very center of this sustainability revolution.

In Chapter 2.6, Bala Mulloth talks about the increased importance of social entrepreneurs—leaders that transcend the traditional distinction between business and the nonprofit sector. The essay tries to clarify numerous misconceptions that have arisen around the definition of "social enterprise." It also offers a strong prediction: social enterprises that aim at achieving some broader social good while at the same time engaging in profitable commercial activity will become increasingly important agents of sustainable social change.



Mulloth's prediction fits the broader narrative about members of Generation Y combining strong entrepreneurial skills with a desire to achieve professional objectives that go beyond financial success.<sup>4</sup> Bernadett Koles contributes to this narrative in Chapter 2.7 through her analysis of the impact of vibrant digital activities and deep virtual immersion on the professional qualities of current and future entrants into the job market. Her discussion differs radically in content and tone from what we often hear about topics such as computer games or social networking sites in the mass media, especially in CEE. Rather than seeing a threat in the digitalization of the environment of today's children and young adults, Koles calls on managers and leaders to harness the unique set of skills digitally educated workers possess.

Chapter 2.8 takes on the topic of innovative education and skill development in the more specific context of business schools. While we do not want to be perceived as biased enthusiasts placing the chapter on business education in the part of the book dealing with global trends, we do believe, despite some predictions to the contrary, that business schools must and will continue to play a pivotal role in the professional development of the incoming generations of managers and leaders. The world, as we have pointed out earlier, is becoming more complex. It seems logical then that high-quality training will become ever more important a prerequisite for managers, entrepreneurs, and leaders to be capable of dealing with such complexity. Tibor Vörös tells us, however, that the condition for the continuing relevance of business school programs is their radical turn to practicality.

### **Part III: New Business Thinking**

The final part of this book is about how new CEE managers, entrepreneurs, and leaders can tap into and leverage cutting-edge business thinking. Based on the experience of our own institution, we think that CEE can become a laboratory of managerial and entrepreneurial innovation. Business schools that are in sync with latest developments in managerial thinking and practice should act as academic, educational, and intellectual catalyzers of this process. But it is CEE firms and their managers, entrepreneurs, and leaders that must develop effective strategies for change and innovation and then implement them successfully.

This call for "intellectual entrepreneurship" in the region is the focus of the preview chapter by Yusaf Akbar. The theme is further analyzed by Mel Horwitch in Chapter 3.2. Horwitch argues that CEE managers and leaders should apply new-style strategy. This includes incorporating new and reconfigured domains of competitive activity, radar for markets, financial resources, products and services, sources of innovation, components of today's complex globalization, and structures of decision making, for example networks and ecosystems. Leveraging such modern approaches and taking advantage of a crisis-triggered burst of energy and creativity, the region can even leapfrog to become a new force for value creation.

In Chapter 3.3, Maciej Kisilowski examines an important obstacle on the way to regulatory and policy flexibility and innovativeness advocated by Horwitch. Kisilowski demonstrates that, for a host of historical reasons, CEE has been heavily influenced by a highly formalistic culture of political decision making. From a senior official in a telecom regulator to an administrator in a local tax authority, CEE civil servants rarely approach their jobs as an exercise in maximizing benefits and minimizing costs for the economy and society. Instead, they are guided by inflexible procedures or dogmas, often mistaken as a representation of the rule of law. Kisilowski calls on businesspeople to insist on changing this bureaucratic mentality.

The rigid regulatory thinking described by Kisilowski is also prominently featured in Davide Torsello's analysis of CEE public discourse. In Chapter 3.4, Torsello uses the case of environmental debates surrounding large infrastructure projects to demonstrate how CEE managers, public officials, and civil society groups often talk past one another. Bureaucrats are frequently shortsighted as they focus intensely on delivering results within strict confines of the EU's top-down approach to economic policy (strongly criticized by Horwitch in Chapter 3.2). The response on the civil society side is to tarnish projects they oppose on environmental grounds with accusations of corruption. The corruption argument resonates well with CEE societies, deeply distrustful of both their politicians and their businesspeople.

In Chapter 3.5, Zoltan Buzady takes the discussion about the need for innovative thinking in CEE from the level of societies and economies to that of organizations. Buzady focuses on the region's persistent inadequacy of organizational leadership. The author starts with a rather conventional premise: Because of its history, CEE has failed to produce inspirational organizational leaders who in the West are often the motors of innovation. Buzady then follows with a provocative hypothesis: Instead of waiting for the CEE version of Richard Branson or Steve Jobs, why do we not experiment with less leader-centered models of organizational design? Buzady has his own original response to this question: the so-called Absorption-based Model of Leadership.

Buzady's model once again highlights the spirit of this volume, which goes way beyond simple replication of Western best practices. The model does not merely summarize state-of-the-art thinking about leadership; it adds a new, original idea to it. It challenges CEE managers, entrepreneurs, and leaders to leapfrog and experiment with new approaches to building their organizations and societies. In Chapter 3.6, Jay Fogelman strongly supports such an approach, by critiquing behavioral finance—a recent influential Western approach for thinking about financial markets. An outgrowth of Nobel Prize-winning scholarship of economists and psychologists, it inspires many of the innovative corporate-finance strategies discussed by Anna Turner in Chapter 1.3. It also is frequently invoked in explanations of the global financial crisis that triggered today's Great Recession as well as the euro crises discussed by Paul Marer in



Chapter 2.2. The promise of behavioral finance is that it is supposed to fix some of the most glaring shortcomings in the traditional “rational actor” account of the economy and financial markets. But Fogelman strongly believes that this intellectually fashionable fix itself needs some lifting. He points to the limited usefulness of behavioral finance, especially in the face of the growing digitalization of global financial markets. He also makes a broader point against uncritical adoption of Western intellectual fads.

### Putting It All Together

After writing our individual chapters dealing with our respective areas of expertise and professional experience, the contributors to this volume gathered for a series of discussions on what we have learned and, in particular, what we can identify as major overall lessons of this exercise. The reports from these discussions are featured in the final chapters of each part of this book.

The entire volume is finally concluded by the authors of this Introduction. Drawing on the lessons from all chapters, we call for a fundamental shift of focus in CEE, away from endless political and ideological debates and toward a dynamic and timely blend of proven professional management and the creative spirit of today’s entrepreneurship. This new managerial stance, which we call *creative managerial professionalism*, can be instrumental in helping CEE managers, entrepreneurs, and leaders push our region closer to a robust knowledge-intensive economy. Our success on this path is important not only because it will positively affect the lives of millions living in CEE, but also because what is happening in the region is relevant for other parts of the world. With active, trained, and self-reflective *creative management professionals*, nurtured by an ecosystem of supporting institutions, CEE can emerge as a laboratory or regional prototype providing pathways for progress on the global scale.

### NOTES

<sup>1</sup> Adam Przeworski, *Democracy and the Market: Political and Economic Reforms in Eastern Europe* (Cambridge University Press, 1991), 10.

<sup>2</sup> All the data in this paragraph is based on authors’ analysis of the World Bank data.

<sup>3</sup> Personal correspondence, January 8, 2013. On file with the authors.

<sup>4</sup> For an oft-quoted voice in that discussion, see Richard Florida, *The Rise of the Creative Class* (Basic Books, 2004).





Stuart Durrant

Chapter 1.1.

PREVIEW:

# CEE BUSINESS ENVIRONMENT THROUGH THE EYES OF A WESTERN MANAGER

## CHAPTER IN BRIEF:

- ❏ Chapters of the first part of the book paint a bleak picture for the prospects of innovation in CEE.
- ❏ The more engaged governments would hardly improve the quality of CEE business environment.
- ❏ Although the overall assessment of the CEE business climate is grim, differences appear when we move to the country level.

**T**he title of this chapter can easily be misinterpreted. The statement that this “preview” has been written through the eyes of a Western manager might be taken to imply that the author is perhaps about to pass judgment on the region; that the connotation of a “Western manager” might indicate an elevated status of knowledge and management practice compared to the author’s counterparts in the region. Alternatively, such a manager-author might be imagined to sit in rapt attention as a student, not a teacher, ready to be inundated with new information that is to be presented to him. This would help him, as an outsider, to have the first inkling, a weak grasp, of what is actually happening and what needs to be given special consideration in this youthful free market. In my case, based on over twenty-two years of management experience

in the region, the truth lies somewhere in-between. Since 1990, I have observed and participated in the transition of the Central and Eastern European (CEE) business environment toward a free-market system. This may suggest a lack of ultimate objectivity through first-time analysis but I trust that my extended familiarity with the business terrain and local idiosyncrasies have enabled me to consider, in context, the offerings of other authors in this volume.

One thing became swiftly clear to me—the first seven chapters of this book do not constitute an attempt to provide a manual or guidebook for how to do business in CEE. Such a complex manual would be superficial to the teacher and frustratingly obscure to the student. Instead, the opening chapters provide a series of vignettes that ultimately blend into a compelling narrative on what to look out for, rather than how to prosper in business terms. Whereas this author would not go as far as to refer to this as a cautionary tale in the grand nineteenth-century tradition, it does constitute a map that should serve as a valuable guide to the unwary.

In the first part of this book, the authors have adopted different geographical approaches to the concept of CEE. For example, Yusaf Akbar and Vukan Vujic take one macro-approach of looking at corruption across many states incorporating the former Eastern Bloc. Noémi Alexa gives a single-country, first-hand analysis of Transparency International's anti-corruption drive in Hungary, while the perspective offered by Charles Mayer limits them to a consideration of retail saturation in one medium-size town just north of Budapest. Nonetheless, the overall picture that emerges from considering the first part of this book is consistent in highlighting many of the issues and concerns that need to be borne in mind and carefully considered while doing business in the region.

### **Trials and Tribulations of CEE's Innovation**

In Chapter 1.2, György Bögel introduces us to the concept of innovation and its changing geography in Europe's emerging countries. Drawing on research compiled from *The Atlantic Century 2011* report on innovation and competitiveness and referencing the EU's Innovation Union Scoreboard, the author points out that none of the emerging countries in Europe are considered to be innovation leaders, despite being able to point to strong growth trends in innovation itself. This however may be considered as simply "making the best of a bad job."

Bögel's observation that private capital accounts for the largest segment of research and development expenditure in Hungary, and Anna Turner's incisive comments on the difficulties associated with raising capital presented in Chapter 1.3 fit together well. The natural conclusion that can be drawn from considering these assertions together is that Hungary, along with other CEE countries with similar socio-political dynamics, is suffering in the innovation stakes from the effect of minimal central stimulus in the field of R&D with severe limitations in the ability to actually raise capital from the private sector. The clear conclusion that Bögel comes to is that Hungary and other CEE countries find



themselves at a crossroads: the damage that has been caused by recent global economic events has made the issue of innovation more relevant, yet in order to get the business environment moving again, these countries must become havens of innovation.

Innovation requires brain power, strategy, and perseverance as well as new idea and approaches. To become a haven, the country must offer an environment in which there is a chance for good innovations to be nurtured and fostered. Turner ends the chapter with a reference to the Hungarian government's program for R&D and innovation in the future. With the best will in the world, the government can only hope to create the backdrop; the acting is to be done by corporations and individuals with the dynamism, enthusiasm, and skill to make their ideas work. The issue of whether Hungary or any other CEE country can weave this backdrop remains uncertain, as does the question as to whether the geographical evaluation of innovative countries has any relevance.

Perhaps the "brightest prospects" from the CEE countries have already left to contribute to other innovation cultures in geographically different regions, thereby blighting innovation attempts in the region. In "New Europe" the transferability of skills, knowledge, and ideas is very high. If the best and the brightest have already established that other territories are the best stage on which to display their talent for innovation, the task of reclaiming them by government decree alone is slim. There will have to be an environment where finance is available, intellectual property (IP) is respected, oversaturation has not occurred, and transparency is high. The chapters that follow address these issues.

Turner takes a hard and uncompromising look at the sources of financing for CEE entrepreneurs and, in the eyes of a Western manager, does not paint a very pretty picture. Incorporating a number of pertinent interviews with parties from the front line of financing, Turner, like Bögel, looks into the relationship between innovation environment and opportunities for financing. The conclu-

sion that she comes to is fairly bleak, namely that traditional sources of capital are thin on the ground and that the scarring the global financial crisis has left is still keenly felt by traditional financiers, be they providers of debt (banks) or equity (business angel/venture capitalists).

The one beacon of hope that does shine through is the relative success of structural funding through organs such as the Joint European Resources for Micro to Medium Enterprises (JEREMIE) Program, which can broadly be considered as a seed fund for small- and medium-size enterprises and is subject to preset strictures in its application. As such, it may be considered a small step in the right direction; however, only a longer-term demonstration of the success and market impact of enterprises benefitting from such structural funds can generate the confidence and awaken the interest of other funding sources.

The prevalence of such risk-averse attitudes is indeed symptomatic of emerging and established regions in business at present. The assessment of risk is, however, always accompanied by the implied measurement of reward and what Turner does not discuss (but what may form the basis for a follow-up research)

is why risk barriers remain unbroken.

The obvious perception is that the rewards on offer, usually by way of potential financial return, do not match the expectations of those who might have funds. Put simply: there are other

There are other destinations that offer higher returns with greater certainty.

destinations for investment funds that offer higher returns with greater certainty.

The wrap-up section examines what might happen if “all else fails.” This chapter gives an interesting example of a Graz-based solar lamp business (which, unfortunately, may not be representative of the region). This company staved off failure by leveraging the power of networking. Private capital from family and friends is indeed nothing new in the business world despite countless cautionary tales highlighting the incompatibility of business and pleasure. Such an example may warm the heart, but will not set the world of business innovation and entrepreneurship afire. Turner’s closing remark that appropriate “mediators are still sadly missing from our region,” tells us much. Trust, reliability, and confidence have always been cornerstones of successful business practice. The absence of these, as highlighted particularly in Akbar and Vujic’s chapter, suggests that the funding environment in CEE is not going to get much better any time soon.

Caterina Sgagna’s thoughts (Chapter 1.4) on the smart use of intellectual property rights aptly follow and complete what might be seen as a “chicken and egg” cyclicity in the CEE markets when considered together with the first two chapters. The issue might be thought of as follows: A lack of innovation leads to a lack of funding; a lack of demonstrable return, which is caused by a lack of ability to protect and profit from one’s innovation, in turn leads to a lack of further investments in innovation and so on. Although this downward spiral is

not the focus of Sganga's chapter, a certain sense of doom is palpable. In this case, however, it is neither the market participants nor the markets themselves that are the source of concern, but rather a pervasive level of ignorance toward the modern relevance and financial clout that a deft approach to IP protection can bring.

### **The Dog and the Fight**

At the heart of Sganga's assertion is the idea that a simple and straightforward reliance on legal and statutory codes and practices is insufficient and potentially damaging. The reliance on the law of the land—dubbed by Sganga “sword and shield”—is of minimal value, unless potential protagonists in litigation have similar financial and time resources to take up a fight on equal terms. The implication is that in the startup phase of business and in subsequent secondary innovation on the job, “it's not the size of the dog in the fight, it's the size of the fight in the dog,” to use Mark Twain's quote. This watchword might equate to “prevention is better than cure.” This is in fact counterintuitive to many natural CEE market participants who, despite the fall of the Berlin Wall and the collapse of communism, have still been brought up in an environment where the regulation of the state is perceived to count for much more than individual endeavor and will. Sganga's advice to businesses to be proactive in seeking solutions and strategies from legal counsel rather than remedies and regulations is a valuable insight indeed.

In Chapter 1.5, Mayer demonstrates that in the retail environment—perhaps the oldest business sector of them all and one where innovation or IP awareness can play little part—it is in fact the size of the dog, or at least the strategic location of its kennel that plays the most important part in business success. The well-documented case that the author has put together on the proliferation of food retailers in Szentendre leaves the readers in little doubt that he has been witness to some form of gold rush, embarked upon by retailers wishing to obtain a slice of the pie in a market that has been inevitably moving from a prevalence of nano-enterprises (the mom and pop stores) to a more mature market driven by supply-chain where larger retailers with more financial clout will prevail.

In the retail industry the three golden rules—“location, location, location” (as espoused by Lord Samuel of property developers Land Securities)—is of crucial value. The visibility, accessibility, and legibility of any branch of retail activity (with the occasional exception of highly specialized outlets) remain crucial. There is indeed a market saturation limit for food retailers, which may ultimately be expressed quantitatively in terms of physical square meters per potential customer in stores' catchment areas. However, as Mayer points out, some of the competitors in the market operate at regional/strategic levels. The author also accurately observes that saturation anomalies are resolved through an M&A mechanism.

Nonetheless, where there is no critical mass of potential customers there is no retail activity. This will be the ultimate determining factor in the overall scale

of retail activity in any location. There is a question as to whether a tradeoff exists on the second class markets of where tolerance of lower quality fare is higher. This might be a face-saving factor for retailers in marginalized locations although this thought demonstrates short termism. It is logical to expect in the long run, when (if?) purchasing power per capita rises in the region, the need for retailers to compete in terms of quality as well as price will become an imperative. Occupiers of those locations that are able to generate only lower turnovers will ultimately perish.

### **The State: Helping Hand or Leviathan?**

The issue of corruption in the region is clearly one that should be of concern to any business executive, regardless of their provenance. In Chapter 1.6, Akbar and Vujic provide a well-documented and geographically wide-ranging look at corruption through a primarily cultural lens. This anthropological approach deals not so much with the measurable impact of corruption and unethical business practices on the bottom-line level, but rather with the social segmentation of a potential workforce in a given country and therefore of the nature, attitude, and approach that one might expect from competitive practices. From a Western manager's perspective, this chapter therefore offers perhaps more in helping to understand a human resources conundrum and less in addressing business-specific issues.

It is interesting to note that, with the exception of Estonia and Slovenia (which are respectively categorized as "individualist" and "egalitarian" cultures), all the countries' cultures have, on account of their high grid score, been categorized as either "fatalist" or "hierarchical." The major implication of this from a Western manager's perspective is that ability and opportunity are considered to be of little value in the region as a whole. Noémi Alexa's remarks in Chapter 1.8 about the opacity of political campaign funding resonate well here. In non-egalitarian cultures the expectations of market participants are skewed in such a way as to accept whatever the state has to offer them, even if that implies that "firms that make financial or in-kind contributions to parties are rewarded with state contracts or favorable regulations once the supported party gets into power." The lobbying of politicians is an old concept, but Alexa asserts that lobbying often equates to outright bribery, even if it is hidden through "a chain of intermediate companies." Her reference to Anna Grzymala-Busse's theory on illicit extraction of funds through the structuring of institutions neatly closes the circle, both figuratively and literally.

The advice given by Akbar and Vujic in their section on "Implications for Managers and Public Policy" offers additional training and motivation to managers, while ensuring that exposing corrupt practices (whistleblowing) carries little stigma or fear of retribution. Alexa's comments on the woeful inadequacy of whistleblower protection and the seeming immobility of the Hungarian government in this regard reinforce the concerns Akbar and Vujic raise on this issue



in the call for whistleblower treatment to be paired with public policy initiatives to challenge entrenched views in hierarchical and fatalistic societies makes much sense. The actual creation of workable mechanisms to achieve this is evidently a different matter altogether. In a world with fewer business borders, the creation of a level playing field to which developed market participants are accompanied has to be considered from a genuinely regional perspective. This in turn implies that the actions of regional sovereign states themselves, individually and collectively, should be the subject of reform in order to achieve a more transparent and consistent business environment. This provides an interesting counterpoint to the comments of Peter Hardi in Chapter 1.7, in which the role of the state as moral guardian of the social interest is examined.

Hardi gets straight to the point, stating that the perception of Corporate Social Responsibility (CSR) in CEE is heavily influenced by what was inherited from the socialist system. The very first example highlighted concludes that the actions of the state under the banner of centrally led CSR can, and do, come at the expense of corporations. The concept of state-mandated schemes born out of centrally conceived responsibility for CSR-style activities should be of great interest to multinational corporations that are built on Western business practices. As Hardi points out, CEE governments are seen to insist on the implementation of substitute activities that would in other business climates belong firmly in the domain of the corporations themselves.

Some actions of CEE governments effectively requiring that players in the private sector must undertake, as a form of wealth redistribution, activities for social benefit, cast doubt on the accuracy of the 'free market' reference in the



Some actions of CEE states cast doubt on the accuracy of the 'free market' reference in this book's title.

title of this book. The inference is that CEE markets are anything but free. The liberty of private sector participants to come to their own conclusions with regard to how to navigate the muddled waters of taking appropriate responsibility

in social matters is severely curtailed. The dichotomy that Hardi explains in terms of social and fiduciary responsibilities is evident. However, the question remains: Does this nanny state approach make for a less competitive and attractive business environment?

Certainly, the suggestion that what has actually been achieved in CEE countries is the creation of a new tax regime under the name of CSR is something that should be of grave concern to private-sector businesses. It is not only the individual who is entitled to feel that taxation should go hand-in-hand with representation. The image that we are given is that the right of private business to determine what constitutes public good is being effectively hijacked by governments' own socio-political platforms. At the time of writing there is substantial international concern over the less than liberal policies being adopted in many CEE states, particularly with regard to discrimination and bias based on

race, religion, and political and sexual orientation. It would seem that corporations in the region are being asked to consider whether they can afford, especially on a global level, to be the passive enforcers of such policy.

### Not a Pretty Picture

All of the above, taken in conjunction with Akbar and Vujic's portrayal of the region's corruption record, supported by the first-hand account of Alexa in which she laments the unwillingness of local companies to support transparency and integrity in business, presents an unrelentingly grim picture of the region as a highly problematic place in which to do business.

Combine these images with Bögel's thoughts on the stifling of the innovative environment, the comments of Turner on the near impossibility of raising

finance in a consistent way, and Mayer's warnings on gold rush instigated market saturation. The prospects of the region being viewed as an attractive business environment recede further for any but the hardiest of corporate souls.



Part I pictures CEE as a problematic place for doing business.

More generally, the credentials of the region as a success story, now that it is out of its teens, appear rather damaged.

A “teacher’s summary” should enter here a caveat that the artificial clumping together of sovereign states under one regional banner can distort the picture somewhat. According to the World Bank, in 1990 GDP per capita in Hungary was 60 percent higher than that of Poland. By 2012, Poland was ahead of Hungary by more than 7 percent. A student may conclude that in order to find out why that is, she should turn to a different book—one that looks at business in a country- and sector-specific way.



György Bógel

Chapter 1.2.

# EUROPE'S EMERGING COUNTRIES AND THE CHANGING GEOGRAPHY OF INNOVATION

## CHAPTER IN BRIEF:

- ▣ The economic crisis accelerated changes in the geography of innovation.
- ▣ Competition for high-end activities intensifies as more countries try to climb higher in the global value chain.
- ▣ CEE needs to embrace innovation as the most important engine of growth.

**T**wo recent headlines found in Hungarian newspapers read:

- (1) A leading global software firm opens a new development center in Hungary.
- (2) One of the largest cutting-edge technology companies in the world reduces the workforce at its Budapest research and development unit.

These two news items appeared in the press only a few days apart in the fall of 2012, reflecting both positive and negative sides of the state of high-tech innovation in the Central and Eastern Europe (CEE). Their common appearance is

incidental but they properly reflect the complicated and contradictory state of innovation in the region, where good news is often mixed with bad news and success is often met with failure.

### Positions and Potential

Recently, a group of prominent researchers warned Europe's political leaders in an open letter that they should not allow for the decrease in funds available for innovation between 2014 and 2020. Advocacy is necessary because the temptation to reduce public expenditure is strong and innovation expenditure must not be compromised; these types of cutbacks would generate serious consequences for Europe's future and competitiveness.

In the United States, the warning bells have been tolling for some time now. In 2009, the Information Technology and Innovation Foundation, composed of independent experts, issued a report titled *The Atlantic Century 2009* on the state of innovation in thirty-six countries. Two years later the organization published another report,<sup>1</sup> extending the survey to include over forty-four countries. This report concluded that the position of both the United States and the European



Both US's and EU's positions are deteriorating in the global innovation competition.

Union is deteriorating in the global innovation competition. Its authors observed the most substantial improvement in Southeast Asia and in certain CEE countries, including Cyprus, Slovenia, Estonia, the Czech

Republic, and Latvia. The report warned that certain developed countries, such as the United States, may enter a destructive spiral without proper measures. They confirm that holding one's ground in the innovation competition requires particularly aggressive advances in promising industries of the future, such as informatics, robotics, nanotechnology, biotechnology, and advanced business services, without losing ground in important traditional business sectors like high-end manufacturing.

According to *The Atlantic Century 2011*, Singapore is the most innovative out of the countries surveyed, followed by Finland and Sweden. The United States, a leading innovation superpower for decades is only the fourth on the list (if individual U.S. states were considered as independent countries we would get a different picture). Regarding innovation performance, the EU15 and the EU25 groups treated as regions were ranked eighteenth and nineteenth, respectively. The EU10 (the predecessor of the current EU11 group of the EU member states from CEE) was ranked twenty-seventh. Austria was seventeenth, the Czech Republic twentieth, Estonia twenty-first and, coming in somewhere in the middle of the list was Hungary, ranked twenty-second.

When comparing the extent of changes in innovation performance between 1999 and 2011, China is seen as the most rapidly and dynamically developing country. Cyprus is the third, Slovenia—fourth, Estonia—fifth, the Czech

Republic—sixth, Latvia—seventh, and Hungary is the eleventh. Developed countries, such as the United States, Sweden, and Germany are ranked among the thirties and forties.

*The Atlantic Century 2011* reflects fierce competition and mobility on the global innovation map. The positioning of former leaders is constantly threatened by dynamically developing countries. The economic crisis that began in 2008 intensified innovation-related challenges. Certain countries have adapted quickly to the new economic conditions, while others have slowed down or halted, further increasing the gap between countries. The initial shock of the crisis caused a negative impact nearly everywhere, from which only certain countries were able to recover. Among the most innovative countries it is worth noting the difference in recovery between Scandinavian countries, such as Sweden and Finland, which have showed sluggish recovery, on the one hand, and South Korea, which has strongly rebounded, on the other.

According to the 2012 report on science and technology by the Organisation for Economic Co-operation and Development (OECD), regarding R&D expenditures, only a very moderate improvement can be expected in the countries hardest hit by the crisis. However, the situation is not as bad in Germany and Northern Europe, where proper funds are still available to support innovation. It is difficult to form an opinion on the future of innovation for countries such as France, Japan, the United Kingdom, and the United States.

### **Moving Up the Value Chain**

The migration of company functions and activities is not a new phenomenon. The relocation of relatively simple forms of production to cheap countries started decades ago. Nowadays, a new phenomenon is unfolding: the geographical rearrangement now involves ever more complex and knowledge-intensive activities. The development of modern information technology and global competition increases the importance of innovation-related activities and R&D in particular. This is a logical, organic continuation of a process that began long ago. This phenomenon, its predictable consequences and associated behavior of its stakeholders, is debated intensively in several forums, which opens the door to some lively discussions.

The leading character in this rearrangement is the United States. The migration of company activities started within its own boundaries; in the 1970s and 1980s, steel and textile industry jobs moved to the cheaper southern states in large numbers. Subsequently, in the 1990s, production activities of the electronics industry were outsourced to Canada, Mexico, South Korea, and Taiwan. By the end of the decade, the Southeast Asian countries became the most favored targets, not only for the United States, but for other developed countries as well. Since the start of the new millennium, China has become the most popular country for production outsourcing.

However, modern-day outsourcing involves much more than production. One of the most spectacular recent phenomena has been the relocation of IT services. Technological development has made it possible for inter-related tasks to be coordinated between countries, even from the other side of the earth. Companies have been able to find acceptable and even excellent workforces in the emerging world. IT services were thereafter followed by other IT-supported activities, such as customer relationship management, accounting, payroll, and staff administration. IT outsourcing and business process outsourcing have become ubiquitous.

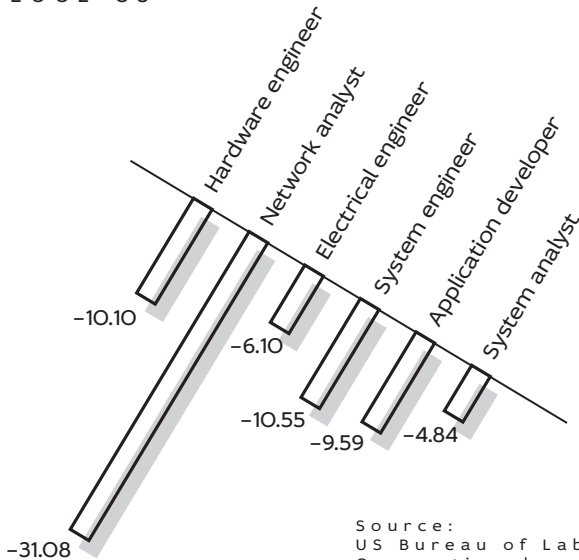
In order to maximize the benefit from outsourcing and IT relocation in IT-enabled companies, they must continually renew their organizational structures. Systematic standardization and consolidation are needed, especially those that are supported by popular models and best practices like Information Technology Infrastructure Library (ITIL) and or Capability Maturity Model (CMM). The more successful this form of innovation is, the more profit can be derived from the services provided.

Undoubtedly, the outsourcing of information technology services and IT-enabled services has seen spectacular growth in certain countries during the first decade of the new century. This evolving phenomenon has significantly

Figure 1.2.1.

Change in the Number of Employees in Certain Cutting-Edge Technological Professions [%]

U S A , 2 0 0 2 - 0 3



Source:  
US Bureau of Labor Statistics,  
Occupational and Employment  
Statistics, 2005

impacted employment figures and trends in the countries involved. For example, Figure 1.2.1 shows how the number of employees in certain professions of the American cutting-edge technology industry decreased during 2002 and 2003.

Regarding the migration of activities, the long-held view was that certain, relatively simple, low-end functions will migrate toward less developed and cheaper countries, which will become the “back offices” of the developed world. These back offices would carry out the less valuable, standardized, commodity-type activities, while the “front offices” in the developed countries would maintain activities such as customer relations, design, innovation, marketing, sophisticated services. From their view, developed countries would have nothing to worry about; market forces in a strong and versatile economy would mitigate the loss of jobs associated with the migration of activities, functions, and sometimes even whole industries.

However, not everybody thinks this way. In business, political, and academic circles, a lively exchange of ideas has emerged with regard to the extent to which previously held notions on free competition and free trade are still valid in today’s world. According to some involved in this debate, when a country lets go of certain activities, then the country risks losing its competitiveness, resulting in a rise of unemployment (see Chapter 2.1 for extended discussion). The authors conclude that the migration of company activities, or at least of high-end ones, has to be avoided, and if necessary, it should be prevented by means of governmental intervention.

The debate is not so simple: there are advantages and disadvantages on either side. What should, for example, the government of the United States do when it finds an increasing number of jobs, even from strategic industrial sectors like aviation, are migrating to cheap-labor countries? Is it better to adopt a *laissez-faire* attitude, or should the state intervene? Is it a win-win situation or will one party lose out? After all, how serious is the threat?

### **Innovation Hierarchies**

One thing is certain—the migration of company functions and activities to China, India, and other countries did not stop at low-end mass production; an increasing proportion of the migration occurs at levels where the workforce requires an ever increasing amount of knowledge capital. To describe this trend in more detail, the following presents the hierarchy of different functional operations activities migrating to new places:

- (1) Simple “back office” activities (e.g., data entry and processing, managing transactions, document management);
- (2) Managing customer relations (e.g., call centers, telemarketing, customer relation management);

- (3) Enterprise basic functions (e.g., accounting, finance, human resource administration, information technology, procurement);
- (4) Expert activities (e.g., market analysis, portfolio analysis, risk management, credit scoring);
- (5) R&D, product, and technology innovation (e.g., design, technology development, research, testing).

There are several causes of this hierarchical progression: it is made *possible* by technological development, and it is made *necessary* by global competition. Because taking over other company's activities has much potential, more and more countries and ventures try to jump on the bandwagon. The new entrants obviously appear at the bottom end of the market and fierce competition and rising costs force enterprises to move up the hierarchy, towards knowledge-intensive functions where margins are higher, strategic positions are more defendable, and the danger of becoming a commodity service provider is less threatening. Thus, the escape route leads upward and this has obviously been understood by many people in the emerging world.

The movement toward the more demanding and sophisticated innovation activities has appeared explicitly in the economic strategy of certain countries. For example, India's National Association of Software and Service Companies (NASSCOM) declared years ago that outsourced engineering services should be targeted by its members. These activities include product development, parts design, production facility plan preparation, and production process and production management system development. The organization's leaders think that engineering services can develop better and faster alongside production that has already migrated.

We can see that the globalization of innovation has been advancing by large steps since the beginning of the twenty-first century. The winners of this process are emerging countries that are able to exploit the opportunities. This is the organic continuation of a process that started much sooner. However, it does raise a series of new issues and questions. The strategic focus of government decision makers is moving toward the development of a knowledge-intensive economy; they intend to motivate the drivers of economic life, build infrastructure, develop regulatory systems, and educate in the spirit of this notion. We can witness the emergence of lively competition with a multitude of players, where positioning in the international economic "food chain" and wealth hierarchy are at stake.

A key concern of this competition is who can make a profit from the geographical movement of the knowledge-intensive, high value-added activities. The geographical rearrangement of company activities is an unavoidable world trend that impacts practically everyone, and it does make a difference whether a country's place will be at the bottom or at the top end of the hierarchy. In this



context, we can look at the EU's 2014 "Innovation Union Scoreboard."<sup>2</sup> Based on a number of factors, it classifies EU member states into the following groups based on their innovation performance:

- ❏ Innovation Leaders, including Denmark, Finland, Germany, and Sweden. Their innovation performance considerably exceeds the EU27 average.
- ❏ Innovation Followers, including Austria, Belgium, Cyprus, Estonia, France, Ireland, Luxembourg, the Netherlands, Slovenia, and the United Kingdom. Their performance can be considered as average among the EU27.
- ❏ Moderate Innovators, including Croatia, Czech Republic, Greece, Hungary, Italy, Lithuania, Malta, Poland, Portugal, Slovakia, and Spain. Their position is moderately below the average.
- ❏ Modest Innovators, including Bulgaria, Latvia, and Romania, whose performance falls considerably below the average according to the survey.

It is apparent that the former socialist countries of CEE are not among the leaders. The report also contains information regarding the growth of the innovation performance.



CEE is clearly not among global innovation leaders.

The improvement pace among the *innovation leaders* is relatively slow, which is understandable: improvement at the leading edge is difficult. The situation is different in the range of countries close to or below

the average performance; Estonia and Slovenia show outstanding growth in the *followers group*, as does Bulgaria in the *modest group*.

The far-reaching implications of this data are difficult to determine without a thorough analysis. In any case, it is obvious that the innovation environment is dynamically evolving in performance and growth. These highly visible differences generate debate among politicians, scientists, and businesspeople everywhere and are especially heated among countries where losing competitiveness is a real and imminent risk.

### Hungary: A Case Study

In Hungary, for instance, the ongoing debate revolves specifically around the strategic role of scientific research, Hungary's financial and institutional background, the international status of Hungarian researchers and developers, and the necessity of state subsidies. Some believe that the amount spent on R&D should be increased while others emphasize that without institutional and strategic reforms this would have little lasting impact. They argue that the country

is too engaged in basic operations. There is quality research carried out in the country but commercialization is poor and the connection between the academic-university sphere and the business world is weak. Typically, others practically implement and derive profit from these valuable scientific findings.

A deeper analysis reveals some of the underlying factors behind the reasons for the state of innovation in Hungary.<sup>3</sup> In 2010, Hungary spent 1.16 percent of its GDP on R&D. The country exhibited strong growth between 2005 and 2010, which made it one of the fastest growing in the EU. However, R&D spending remains far below the 3 percent target set by the European Council in 2002. The country's current plan is to reach 1.8 percent by 2020, but Hungary's expenditures on R&D have stagnated since 2009. The ratio of these expenditures to the GDP was the highest in 2002 and has decreased since, with the exception of a slight increase in 2009. Further, private capital accounted for largest segment within R&D expenditures in 2010. Enterprise R&D expenditures have grown dramatically since 2000: their average growth rate reached 9 percent annually. In 2000, this accounted for only 0.36 percent of the GDP, almost doubling to 0.69 percent by 2010.

The country's economy has a relatively strong manufacturing sector, much of which is owned by big multinationals. A large proportion of the R&D expenditures are generated by the local affiliates of the global parent companies. The mainly small- and medium-size enterprises that are domestically owned show very moderate innovation activity and only a few of them are active players in innovation. The large manufacturing companies often finance research programs at local scientific institutions. Many of the researchers have large international networks and numerous scientific articles are published with international cooperation. However, the number of patents submitted compared to GDP is lower than the OECD median (see Chapter 1.4 for a broader discussion of the role of patents and other intellectual property rights in CEE innovation).

After the fall of communism, the info-communications infrastructure of the country began a spectacular development; however, this was not enough to make Hungary an innovation leader. Currently, the e-government readiness index is below the OECD median. Approximately 1.5 million ventures are registered in the country but only half are active. Opinions on the quality of education vary and the low level of language proficiency hinders the country in joining international cooperation and trade more actively. In addition, doctoral graduation rates in science and engineering studies are well below the OECD average.

### **Innovation Crossroads**

Although conclusions may differ, it is clear that CEE has arrived at strategic crossroads. The economic crisis divided the national economies along the lines of innovation. The shock has slowed down or paralyzed certain countries that may continue to lose ground in the race for a global innovation advantage. At the same time, some countries have gained considerable growth, especially in South-

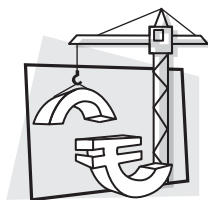
east Asia and CEE. Regions and countries at this crossroads of innovation must fully embrace innovation to restart the engines of their economy, attract investors, and generate jobs with high added value. Innovation activities are highly mobile, geographically flexible and will seek the most favorable locations.

In November 2012, as this chapter was prepared, the Hungarian government published a program titled *Investment in the Future: National Research, Development and Innovation Strategy 2020* available on the homepage of the Ministry for National Economy. Each strategy is worth as much as the value created through its implementation.

## NOTES

- <sup>1</sup> Robert D. Atkinson and Scott M. Andes, *The Atlantic Century II: Benchmarking EU & US Innovation Competitiveness* (Information Technology and Innovation Foundation, 2014).
- <sup>2</sup> “Innovation Union Scoreboard 2014” (European Commission, 2014).
- <sup>3</sup> “Technology and Industry Outlook 2012” (OECD, 2012).





Anna Turner

Chapter 1.3.

# NEW WAYS OF FINANCING CEE ENTREPRENEURS

## CHAPTER IN BRIEF:

- ▣ Economic crisis calls for changes in financing methods of CEE SMEs.
- ▣ Traditional channels are not flexible enough to meet the needs of high-risk, undercapitalized companies.
- ▣ New financing channels such as business angels, crowdfunding, and venture capital are starting to gain acceptance in CEE.

**W**hen one thinks about corporate finance in Central and Eastern Europe (CEE), the first thing that comes to mind is conventional bank financing. Here, the financial system has been traditionally bank-based, but with the Great Recession upending established economic patterns, the limits of the bank-centered approach have become evident. With more defaults of corporate customers and the general atmosphere of caution that followed the credit crunch of 2008, banks have become increasingly stringent in providing credit. In Hungary, the situation has been exacerbated by the significant sector tax that has been levied on banks, further limiting their willingness to lend in general, let alone to provide credit to small and medium size enterprises (SMEs), which have always been considered risky business partners.

Although the consequences of the lack of traditional credit are obviously harmful for SMEs, there might be an element of opportunity in the current crisis. Entrepreneurs may, in particular, look at more cutting-edge ways of financing



Lack of traditional credit might become an opportunity.

their ideas. This chapter sketches a new, more nuanced picture of financing opportunities for CEE SMEs with a particular emphasis on the Hungarian economy. I do not intent to sugarcoat the reality. These new ways of financing

are underdeveloped in the region, which surely contributes to the overall weak innovative potential of CEE, discussed by György Bögel in Chapter 1.2. But the consideration of the broader variety of options is needed nonetheless.

In general, SMEs are financed through internal resources and when these are not enough, they either try to attract investors or rely on external sources such as advances from customers, factoring accounts receivable, stretching payments to suppliers, loans from relatives, acquaintances and banks, and leasing.

### Business Angels

All new businesses stem from entrepreneurial ideas: why not sell indoor boomerangs, portable disposable toilets, or ergonomic pens that help kids learn to write? In the beginning there is no management, no structure, just innovative ideas. Crisis or not, it is virtually impossible to find a bank that would be willing to finance a business at this stage. Banks lack the means to assess the potential of an idea in question, and the nature of developing and evolving ideas does not lend itself well to their rigorous risk assessment processes.

Thus, even before the crisis, entrepreneurs were forced to look elsewhere for funds to move beyond the idea stage. In CEE, the usual channels have been personal savings as well as informal loans from family or acquaintances. In more established economies, significant players are wealthy individuals known as *business angels*. In our region, the market for such angels has just started to come into being. Most entrepreneurs do not have broad social connections and the number of wealthy persons willing to take significant risk for the prospect of high return is limited.

Moreover, there are a few channels through which SME entrepreneurs and the wealthy may connect with one another. One of these is a Hungarian web-based matchmaker called Üzleti Angyalok (Business Angels).<sup>1</sup> The company offers about €10,000 for investments and welcomes newcomers to share their business ideas. For potential investors they offer one new company/idea per day. This may not be a lot, but for a small market it is something to begin with.

Day One Capital is a Budapest-based business angel. As a venture capital hybrid, it owns a fund (private investments), but the company does not mind working with the entrepreneurs from day one. It closed its first deal recently, which was valued at €240,000.

## Venture Capital

Once a new company is founded, the management organized, licenses obtained, business plans created, financing options broaden. In the established economies, a key addition here is *venture capital*. This is usually provided by venture capital funds that become investors (or get the option to get shares) in a target company. The aim is not to become a long-term partner and receive dividends, but to help the company develop in order to significantly increase shareholder value; and then sell the stake and move on to another project in a couple of years.

In the United States, venture capital helped establish today's success firms—Apple, Google, Facebook, eBay, and FedEx. In CEE, venture capital financing still plays an insignificant, however, growing role. In Hungary, for example, it presents one of the few booming financial sectors. Investment activity in the region is highly concentrated in the larger countries; as of 2011, Poland, Hungary, the Czech Republic, Romania, and Ukraine are responsible for 92 percent of the total investment value in the region. Poland attracts an increasing proportion of this investment and accounts for more than half the market (55%), followed by Hungary (16%) and the Czech Republic (11%). The biggest growth in investment value was achieved by Hungary, which doubled venture investments in 2011. Poland came next with 3.6 percent growth, while investments generally decreased in the remaining CEE countries.<sup>2</sup>

This breakthrough in Hungary was achieved by the EU-financed JEREMIE Program, which has provided about €3.5 million for investment in startups through eight venture capital firms. The financing mix (30% private investment and 70% JEREMIE funds) has proven successful. The government capped the return that the state may collect, thus further profits went to the private investors (private persons or financial institutions).

The support of startups with new ideas and innovations is especially vital for CEE to increase competitiveness. As Bögel explains in Chapter 1.2, being a low-cost manufacturing destination for Western European companies is not a sustainable economic strategy, as there will always be cheaper countries to outsource to. There has to be a revolution in how this region approaches innovation to attract investment in the long run. Dr. Levente Zsembery, CEO of BNV Equity, finds the program an ultimate success. “Budapest has become a startup hub with incubator houses, co-working accelerator programs, spin-off firms from university projects and lively blogs,” he says. BNV Equity currently has nine clients, totaling an investment value of €5.8 million, and most of them are success stories including businesses in the biotechnology, IT, and R&D fields. There is no shortage of capital, but rather of eligible applicants. Zsembery and his colleagues had to check 350 applicants to find their nine clients. The main problems involve lack of good management, business experience, and good judgment; many startups think they have no competitors (“more likely, they do not know about them,” reckons Zsembery) and they have a tendency to forecast

unrealistically high revenues of several billions (in HUF; €10–20 million) for the next couple of years.

Many firms are being discovered abroad as well, like the Szeged University team of Antavo (an online promotion material editor), which received a €50,000 investment from Seedcamp.<sup>3</sup> This latter organization is a European investment fund launched in 2007 to collect money from investors to channel it to the most promising startups. Seedcamp-financed startups can tap into a network of thousands of mentors and receive office space at the Google Campus in London.<sup>4</sup> The organization celebrated its fifth birthday in Budapest last November, focusing attention on the importance of the CEE region. A similar northern European and Russian organization, Startup Sauna, held a selection event for startups in Budapest for the first time in September 2012.

Despite the growth, the region still lags behind Western European levels of



CEE still lags behind Western levels of venture capital investment.

venture capital investments (as a percentage of GDP; see Figure 1.3.1). Even the top two countries (Poland and Hungary) fell under the European average; both have around 0.2 percent venture capital investment-to-GDP

ratio, which demonstrates that there is still potential in the region for extending venture capital investments.<sup>5</sup>

The drawbacks of CEE when compared to Western Europe include less liquid capital markets (except Poland), volatile currency rates, and less predictable regulatory environment combined with uneven level of education and low level of language proficiency. However, the CEE countries are trying to compete with generous tax incentives and subsidies, and the entrepreneurial culture is continuously developing, thus the opportunities for venture capital investors are attractive.

JEREMIE will continue to launch new support funds of €50 million per year for startups.<sup>6</sup> As these companies would have very limited access to bank financing or chances of attracting investors on their own, this seems to be a good opportunity for local talents.

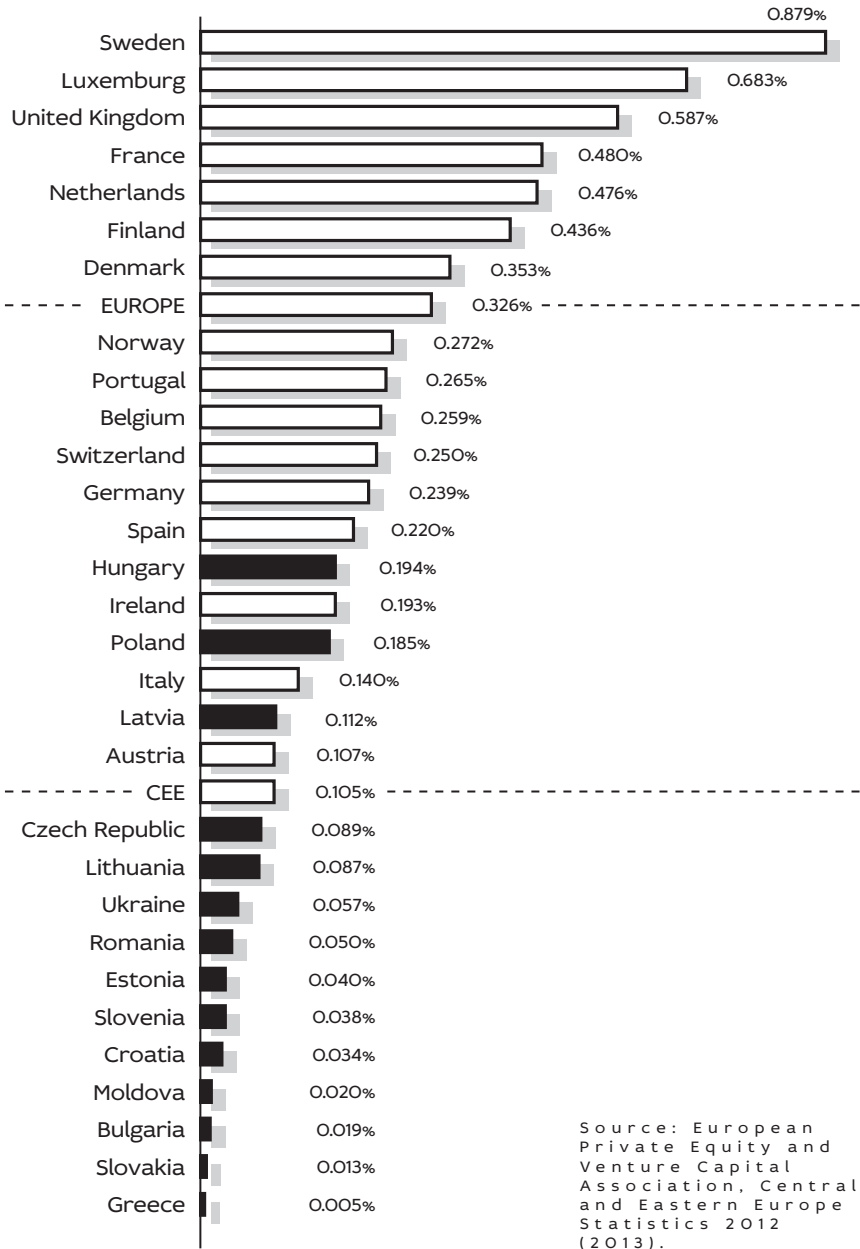
## Crowdfunding

Crowdfunding is a financing possibility where a number of small donors organize themselves—usually via the Internet—to support a venture they care about. The first famous crowdfunding initiative was that of a British rock group called Marillion in 1997. Marillion's fans wanted the band to tour the United States, but the group did not have sufficient funds to organize it. The fans collected donations via the UseNet US newsgroup, and the band upon seeing such dedication promised each donor a free CD from one of the shows. The initiative went viral and Marillion raised \$60,000. Moreover, they have since used this method with great success as a way to fund the recording and marketing of their albums.<sup>7</sup>



Figure 1.3.1.

Private Equity Investments as a Percentage of GDP for Europe, CEE and Selected European Countries



The resource of crowdfunding is social network capital. Networking is important; however, Internet sites launched in the 2000s, like Kickstarter (2009) or RocketHub (2010), have connected the ideas and the “crowd,” forming a powerful new funding channel. Nowadays, there are over 500 crowdfunding platforms all over the world—such abundance that finding the right one for a particular project is challenging.<sup>8</sup> The key to effective crowdfunding is that entrepreneurs need to access the right audience who are willing to offer small amounts to help startups develop and market their product or service.

In Hungary, there are three crowdfunding websites: indulj.be, kezdheted.hu, and CreativeSelector. Despite the success of crowdfunding websites overseas, these national sites have only been launched in the past few years. Indulj.be currently has two promising projects; one is a sci-fi novel that encompasses a creative marketing method—supporters can become hero(in)es in upcoming novels for a €100 and those who contribute more are entitled to a personal space in the book’s Pantheon of Gods. Osszedobjuk.hu is a new initiative, which hopes to capitalize on TV advertisements; however, its portfolio is widely varied, including charity.

### Government and the EU

The European Commission is aware of the strong role that micro and small enterprises play in the economy and society. In 2007, it launched the JEREMIE program. The most sizeable part of the program is not related to supporting venture capital, however, but rather to more conventional lending.

Yet, the lending business is not without problems. The small size of firms and loans to be disbursed has resulted in large workloads for commercial banks that are supposed to administer the loan program. It is simply not worth their time to manage hundred-or-so entrepreneurs for a couple million euro credit opportunity. In Hungary, the Orbán administration understood this problem and, in 2011, began to engage private financial firms and foundations to distribute JEREMIE loans among SMEs.

Gábor Széphalmi, the CEO of one such financial firms (Első Hitelkapu), understands the banks’ hesitancy to participate. “It is enormous work,” he says. “We have placed around one billion HUF [€3.5 million] since our founding, and dealing with the 200 clients we have is a handful.”<sup>9</sup> The upside is, however, that with the laborious process of selecting and educating suitable clients, the default rate is marginal. Első Hitelkapu does not rely on a computer scoring system; the potential of a startup is assessed based on qualitative factors, such as in-depth interviews with entrepreneurs, during which potential pitfalls in their business plans are addressed. “Skeletons usually fall out of the closet at this point,” observes Széphalmi. Numbers can be misleading; experience and intuition prove to be much more valuable tools. But even Első Hitelkapu cannot afford to deal with every issue, like financing of current assets, due to the even smaller loans with an ever increasing work load to analyze details.

In addition to lending, JEREMIE also provides bank guarantees, albeit this sector has been met with limited success.

### **Internal Growth**

One of the few role model companies in Hungary is a chocolate manufacture called ChocoMe. It was founded by the thirty-three-year-old Gábor Mészáros, who was brave enough to start his enterprise during the economic crisis in 2009. With a business degree from a British university, he defied the Hungarian pessimism and stubbornly believed that a new type of chocolate product line could be introduced to the Hungarian market. “Most of my acquaintances called me crazy,” he says “and questioned my ability to sell on a market that is covered by international big names.”<sup>10</sup> But Mészáros saw a market niche—nobody offered personalized hand-made chocolates, chocolates that could contain any ingredients the customers want, let it be Hawaiian black salt or violet petals.

Mészáros managed to finance the company by the internal profits only, and these came already during the first year of operations. With the owner working until 2 am at times, ChocoMe made an €85,000 profit in 2009.

In the summer of 2012, Mészáros was able to invest in a chocolate factory, mainly using his retained earnings. He also made money from the sale of franchise rights to Australia, which helped him finance the investment. Nevertheless, he was still lacking cash to finish the project. Luckily, at that time he was already in a position where banks were contacting him to offer him credit, although he still had to put up his family house as collateral. “The banks are cautious,” he says, “but it is still better than having investors. As long as we can generate enough profit, and with a bit of help from the banks, we can continue to use our retained earnings.”

### **Banks after All?**

This brings us to the next question: Can SMEs get financing from the banks? The answer is a definite “yes,” according to Csongor Németh, the SME expert of CIB Bank Hungary.<sup>11</sup> But certain trends and practices of SME clients make banks cautious. Credit lines, which are supposed to provide temporary financing of current assets, are often kept refinanced, effectively becoming long-term financing sources. This translates into a significant risk for banks, considering the possibility that a client does not manage to find a new short-term loan to pay back the old one. With credits of longer maturity, entrepreneurs obviously have more breathing room.

More generally, Németh believes that the high default rate in the SME loan segment is mainly caused by three factors. First and most obvious is the unsuccessful business model, often exposed ever more quickly due to the crisis. Second, in Hungary and many other CEE countries, SME owners followed the dangerous tendency of relying on private mortgages, taking loans in foreign currencies. Those loans, most dramatically the ones denominated in Swiss francs,

have become prohibitively expensive following the recent depreciation of many CEE currencies against the Swiss franc and euro. Third, entrepreneurs often overestimate their future performance and invest beyond means. This attitude was unfortunately encouraged by the relative oversupply of bank loans before the credit crunch.

“Bank portfolios in the SME segment have become smaller, but cleaner,” Németh concludes. Some industries have seen a huge drop in the number of firms. In the car parts manufacturing, for example, only a handful of companies



Banks try to be more client-oriented, but radical change is unlikely.

survived. Banks still give credit to good firms (“at least 80% of our clients are financially healthy,” Németh adds), but they experience a reduced rate of demand due to the decreasing corporate investment. Factoring (pre-financing

the receivables by the banks) and the demand for lines of credit remains strong, however. Banks try to respond to changes by being more client-oriented, but a significant change of the current patterns is unlikely to happen in the near future.

### What If All Else Fails?

A significant number of CEE companies have gone bankrupt over the past two years. As demand for their products and services collapsed around them, many did not stand a chance. Indeed, some of them may have survived had banks understood their business situation and used qualitative solvency assessment criteria instead of standard quantitative models during assessments. Unfortunately, the usual practice is that numbers are plugged into a computer, and as in the British comedy show *Little Britain*, the entrepreneur gets his answer, “The computer says, ‘No!’”

That was the answer that Austrian businessman Gernot Schneider<sup>12</sup> heard when he desperately tried to survive the insolvency process in 2012. His company got into trouble when sales for his award-winning solar lamp plummeted due to the crisis. Southern European clients in countries such as Greece and Cyprus canceled orders as they became insolvent themselves while Schneider waited for new projects to arrive. To make matters worse, Middle Eastern clients postponed their orders due to uncertainty surrounding the events of the Arab Spring. Schneider had only three months to get out of insolvency. Fortunately, a large order came from the United States. It could save his company if he could only find a way to stay afloat for three more months. He needed €30,000 to bridge the gap. His Graz-based corporate bank, however, said: “No.” No to a business that had a shareholder value of €20 million just a year ago, before the onset of the financial crisis.

Desperate to save his company he had been building for seven years and with only enough resources to keep it going for two more weeks, he organized over

a dozen lunches with acquaintances who could serve as potential lenders/investors. Fortunately, one of these meetings ended in success. The company made it. New orders were obtained in the following weeks, and the company became profitable within just a couple months.

Borrowing money from people who are close to the entrepreneur is not new. However, at times when business risks are high, the role of people who trust the entrepreneur may be more important than ever. If one sticks to the general rule to borrow only from individuals who are in a position to lend without risking their own financial health, this option can serve as one of the most effective ways to fund a business. In established economies, such as in the United States, this financing method is even institutionalized; specialized companies offer a service for managing the process of borrowing from people the entrepreneur knows to ensure all parties involved are comfortable with the deal and confident that all loans will be paid back on time.<sup>13</sup> Unfortunately, such mediators are still missing in our region.

## NOTES

<sup>1</sup> See [www.uzletiangyalok.hu](http://www.uzletiangyalok.hu) (accessed 5 Dec. 2012).

<sup>2</sup> See [www.evca.com](http://www.evca.com) (accessed 10 Jan. 2013).

<sup>3</sup> See [www.debrecebar.hu](http://www.debrecebar.hu) (accessed 15 Dec. 2012).

<sup>4</sup> See [www.seedcamp.com](http://www.seedcamp.com) (accessed 6 Dec. 2012).

<sup>5</sup> See [www.evca.com](http://www.evca.com) (accessed 10 Jan. 2013).

<sup>6</sup> See [www.hvca.hu](http://www.hvca.hu) (accessed 10 Jan. 2013).

<sup>7</sup> See [www.music4point5.com/blog/the-marillion-story-and-what-we-can-all-learn-from-it](http://www.music4point5.com/blog/the-marillion-story-and-what-we-can-all-learn-from-it) (accessed 6 Dec. 2012).

<sup>8</sup> See [www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy](http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy) (accessed 30 Nov. 2012).

<sup>9</sup> Interview with Gábor Széphalmi, Első Hitelkapu Pénzügyi Zrt.

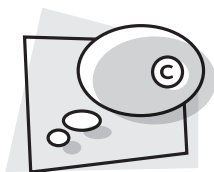
<sup>10</sup> Interview with Gábor Mészáros, ChocoMe.

<sup>11</sup> Interview with Csongor Németh, CIB Bank Hungary.

<sup>12</sup> Interview with Gernot Schneider; names changed to protect anonymity.

<sup>13</sup> [VirginMoney.com](http://VirginMoney.com) (accessed 7 Dec. 2012).





Caterina Sganga

Chapter 1.4.

# THE DOUBLE FACE OF JANUS: OR HOW CEE ENTREPRENEURS CAN USE INTELLECTUAL PROPERTY RIGHTS SMARTLY

## CHAPTER IN BRIEF:

- ❏ Companies often underestimate the importance of IP in strategic management.
- ❏ To compete globally, CEE businesses need to develop a new IP culture.
- ❏ Sophisticated IP management helps mitigate legal risks, save costs, generate revenue, enhance competitiveness, and build industry networks.

**V**onage was one of the first Internet telephone companies to enter the telecommunications market in the United States. From 2000 to 2006, the firm was able to provide its 2 million subscribers a Voice over Internet Protocol (VOIP) service through traditional landline devices. Verizon, AT&T, and Sprint, disturbed by the new competitor, launched three separate litigation proceedings against Vonage, alleging patent infringement. Although the claimants' intellectual property rights (IPRs) would likely have been struck down by the court as invalid, and despite the fact that their claims of infringement were probably unfounded, Vonage settled the cases for almost a quarter

of its annual revenue, and was forced to scale down the company's development plans for a long period.

When Nova Biomedical introduced its innovative and highly profitable blood glucose meter and was subsequently subjected to similar litigation proceedings, launched by Abbot, Roche, and Medtronic, its managers immediately realized the predatory nature of the lawsuit and decided to settle the dispute in court. Nova ultimately prevailed, but not without bitter costs. The founding shareholders needed to lay off sixty employees and take millions in bank loans to pay part of the \$31 million spent on legal services and fees.

A few years before, Connectix and Bleem, two small companies producing PlayStation emulators for Macintosh and Windows computers, were sued by Sony on the grounds of illegal circumvention of Digital Right Management (DRM) systems and copyright infringement. Neither Connectix nor Bleem could bear the high litigation costs and decided to retire their products from the market. The same happened to OWC, a small retailer of Apple computers, when it launched a software that allowed Mac owners to use the iDVD program on older versions of Macs unequipped with internal DVD players.

Academic journals and hi-tech blogs discuss many examples where the aggressive use of intellectual property (IP) litigation acts as effective barrier-to-entry for SMEs. The budget of a small entity is typically unable to cope with the highly expensive and long infringement proceedings. These attempts aptly demonstrate the complicated, double-faced nature of IPRs; here, the role of patents, trademarks, and copyrights as main engines of innovation has been supplemented with socially undesired features. Today patent thickets, defined as "a dense web of overlapping intellectual property rights" surrounding specific technologies,<sup>1</sup> have become the protagonists of entrepreneurs' nightmares: small businesses need to bargain (and pay for) innumerable licenses before they could legitimately begin to commercialize their new products. New high-tech companies strive to widen their IP portfolio beyond the rights covering their core products, with the hope that they may admitted to the elitist circle of market competitors who build joint patent pools and engage in cross-licensing to protect themselves from litigation. Non-practicing entities, negatively labeled "patent trolls," amass patents with the sole aim to sue big firms and force settlements, as they did with RIM and its Blackberry system. As a response, there are now new companies that operate as patent aggregators, offering market players ready-to-buy patent, copyright and trademarks packages that can be used as bargaining chips or in defense against predatory litigations. The strategic acquisition of IP assets on the marketplace has become commonplace, as licensing deals continue to reach higher degrees of sophistication. And the list of problems goes on.

### **From Replicators to Innovators**

Despite being the subject of growing coverage in specialized journals, best-seller books, and university programs, sophisticated IP management is still con-





sidered too infrequently a must have managerial skill. This attitude is slowly changing in Western Europe, where executives show a growing understanding of the importance of embodying IP in strategic management to maintain competitiveness and capture value from intellectual capital. However, Central and Eastern Europe (CEE) lags behind, often anchored to an old-fashioned view of IP as a dusty legal affair or as an inevitable cost to protect internal innovation from free riders.

There are many reasons that underlay the gap, but the first and foremost resides in the industry structure of CEE. After the fall of the Berlin Wall, the most knowledge-intensive firms, which had high variable costs to amortize and which had already been severely hit by a lack of financing and drop in demand, could not stand the competition from the west. As a result, they pulled away from the market. The companies that managed to survive were often those that specialized in cumulative innovation that is in the development of quality improvement processes and in improving the cost-effectiveness of existing products.<sup>2</sup> Such a trend may explain the peculiar co-existence of low investments in R&D<sup>3</sup> and increased industry productivity, as well as justify the passive approach toward IP, as its relevance drops with the decreased knowledge-intensity of a firm. As was explained in Chapter 1.2, this disappointing trend is most visible in case of domestically owned small- and medium-size enterprises.

The situation did not change with the advent of foreign direct investments. Multinationals, which brought their production to the CEE region, rarely transferred their R&D departments and practically never their IP teams. In addition, their late, mostly vertical integration with the regional industries triggered an even more localized movement toward secondary innovation, which in turn gave a characteristic imprint on national industries and their subsequent development.

Despite the great progress made by CEE economies in narrowing the gap in GDP per capita and productivity with Western Europe, scholars and analysts agree that the sustainability of the region's growth can no longer rely on the mere amelioration of existing and borrowed technologies. The vulnerability of the region vis-à-vis the risk that multinationals may eventually leave for lower-cost destinations further emphasizes the importance of a revolution in the way which CEE approaches innovation, as clearly emphasized in György Bögel's analysis of the "innovation crossroads" phenomenon (see Chapter 1.2). Such a revolution must involve both the commercialization of new products and services and the production and protection of intellectual capital to generate value and attract investments. As a matter of fact, structuring and implementing effective IP policies is one of the most basic prerequisites to have access to the new financing channels described by Anna Turner in Chapter 1.3.

The experience of SMEs and big enterprises in IP management suggests that a more proactive approach toward IPRs can unveil a plethora of value-creating opportunities, enhance competitiveness, help in structuring a fruitful industry network and, consequently, boost the innovation cycle. At the same time, a more conscious approach to IP management can help to mitigate the risks, develop effective strategies to access external innovation and transform what is usually a costly source of perils into a profitable revenue generator.

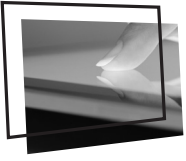
### **Not a Hopeless Road**

The road to acquire a patent or a trademark can be long and costly. Time and money are two variables that may often convince an SME to give up and protect its innovation by other means, such as within trade secrets. At the same time, as it happened to Vonage, Nova, Connectix, and Bleem, entering the innovation arena may carry significant risks. Whether it is the need to acquire external intellectual capital on complementary technologies to prevent the devastating effects of predatory litigation or simply to overcome entry barriers created by competitors, IP represents a necessary key to success in an innovative enterprise.

These are just some of the reasons why the strategic management of IP should start before the acquisition of IPRs with what is called the "innovation triage."<sup>4</sup> During this three-step process, the company is supposed to acquire all the necessary information related to types and sources of intellectual capital needed for developing and commercializing a new product or service. Then, if the source is internal, the firm should strategically plan the protection of its own inventions and creations, carefully avoiding clashes with existing IPRs; and if the source is external, the firm should seek to gain legitimate access in a safe, quick, and cost-effective manner. The aim of the analysis is to ensure that the process of building the company's IP portfolio is aligned with the firm's overall business strategy, while keeping in mind all the foreseeable risks and budget factors.

Due to the complex nature of the subject, IP management calls for the abandonment of rigid and anachronistic separations of competences between different

corporate functions. It is not accidental that entities with large IP portfolios and a sophisticated range of related activities usually centralize their management in



IP management calls for abandoning walls between corporate functions.

a team of technical, business, and legal experts, which reports directly to the top management. Whatever the size of the firm may be, the interaction between different areas of professional expertise remains fundamental to ensure a secure

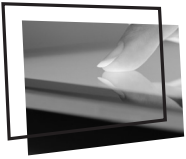
and effective connection between IP and business goals.

The importance of an interdisciplinary approach is well illustrated by the process of shaping patent claims, especially with inventions at an early stage of development. Narrow claims, limited to features already tested, make the patent application stronger and faster to file; however, a broader coverage may be more effective in preventing competitors from “inventing around” or for extending the exclusivity to other sectors, where possible uses of the invention have not yet been explored. A solution may be to temporarily opt to keep the innovation as a trade secret, wait, and then apply with a broader scope. The same attention to underlying strategic objectives is required to decide whether to file a single all-comprehensive patent, or to protect the technology by means of a patent thicket. In fact, although more patents equal higher filing and maintenance costs, a thicket may be fundamental in technology sectors characterized by high cumulativeness of innovation where the establishment of a real competitive advantage requires the creation of large entry barriers. In addition, strategic considerations lie behind decisions concerning the regions in which to file a patent, and how to manage the trade-off between maintaining the innovation as a trade secret and pursuing patent protection, and the advisability to directly opt for shorter but cheaper utility model protection.

When external innovation is involved, IPRs play an even more important role. The smaller the firm is, the more painful it can be to face the high cost of licensing or, even worse, the unwillingness of another company to authorize the use of its intellectual capital. Considering the price at stake, it may appear paradoxical to notice that so few managers are aware of the full plethora of different options available to overcome such difficulties. IPRs, for instance, are temporally and geographically limited, and modifying the expiration of the term of protection or its geographical scope may often be more effective than pursuing a long and expensive deal. Similarly, entry barriers can be diminished by the use of a compulsory license. As a relatively flexible tool, such a license obliges an IP owner to accept the use of his patents or copyright in exchange for non-bargained royalty fees, which are determined either by law or in court. Finally, no IPR is absolute; multiple limitations and fair use exceptions apply. From the experimental uses of a patented invention to the development of dependent innovations, to the reverse engineering and security testing, the list of exceptions is not short. Even in the field of copyright, where exceptions have traditionally been rigidly con-

ceptualized, courts have started adopting a less formalistic and more pragmatic approach, taking into account the business and economic implications of their decisions.<sup>5</sup> Since law in action is a body in evolution, each rule is potentially open to new interpretations. Here, the interaction between a business owner and his or her attorney can play a key role in leading the development of innovative changes in legal and policy agreements.

It is clear that the method of handling intellectual assets can be critical in deciding the fate of a company, and that a manager cannot merely rely on serendipity or technical legal advice when dealing with IPRs. However, the innovation triage represents a mere starting point. In fact, a company may have an arsenal of patents and trademarks that makes it feel safe in its position, but then, as it happened to Vonage and Nova, a cohort of big players may knock at its door and cordially force it to pull its product off the market. Similarly, a patent troll may suddenly and unexpectedly target its IP, as has happened to RIM. Due to the high cost of litigation, dealing with the problem when it appears may already be too late. That is why firms with experience in IP management have developed processes to monitor the external environment and identify signs and sources of



Managers cannot merely rely on technical legal advice when dealing with IPRs.

risk. The suspicious and quick filing/acquisition of patents that can interfere with the commercialization of a company's product may indicate that there is an intent to launch aggressive predatory litigation. In such cases, aside from

seeking the help of a skilled legal adviser, other measures can be employed to protect the company. Actions such as defensive patent aggregation, formation of patent pools, or entering into cross-licensing deals can be used as effective tactics, given that their implementation anticipates the associated risks. The only thing that can ensure the timeliness of such strategies is a proper monitoring process.

### From Risk to Opportunity

If risk management alone justifies the importance of developing an IP culture, the relevance of IP management in the success of an enterprise does not end here. In fact, a more sophisticated approach to the subject may offer a number of usually overlooked cost-saving and value-generating options.

Usually, after being reassured that the innovation embodied in the products or services that they are going to commercialize is fully protected and does not create problems of infringement, companies tend to forget about their IP portfolio. Licenses keep on running with their royalties, patents remain in the warehouse with their annual maintenance fees, and at the end of the year, their costs remains hidden behind general budgetary items. A possible solution to such inefficiency lies in the periodic implementation of so-called IP audits (or IP qualitative evaluation) in the form of asset listing and product review. By classifying the IPRs owned by the company according to different criteria (e.g.,

duration, territorial scope, effective utilization, connection with commercialized products and services) management may gather information necessary to discontinue unused and outdated licenses or IP rights. Dow Chemicals was able to achieve a \$40 million cost-saving measure by simply ending annual payments on 10,000 obsolete patents. How? Concerned about the amount of maintenance fees on its 24,000 multi-state rights, the board decided to assign the cost of each to its associated business unit, thus providing targeted incentives to re-evaluate the potential use of each patent against the company's strategic objectives.

An IP audit helps to maintain up-to-date records of IPRs. Such records assist companies to initiate the renewal of expiring trademarks and to plan alternative strategies to maintain competitive advantage once patents expire. More advanced analysis includes the so-called process review. The process review analyzes the often flawed functioning of basic procedures such as employees' invention disclosure programs, the selection of innovations worth protecting, training on IP matters, and internal protection of trade secrets. Its positive impact on the company's ability to manage and capture value from its IPRs increases proportionally with the expansion of the portfolio.

An IP audit is of utmost importance when a company looks at IPRs as value generators. When IBM was "on the ropes financially, with only a hundred days' worth of cash on hand,"<sup>6</sup> it was through a deep review of the company's IP portfolio and practices that Vice President Marshall Phelps managed to develop one of the most successful licensing programs in the history of IP management; a program with revenues in excess of \$1.5 billion annually. With much less effort and analysis, SMEs can do the same. Indeed, due to financial pressures and a lack of manufacturing/marketing capabilities, some SMEs have already demonstrated an enhanced propensity toward the monetization of intellectual assets than their larger competitors.<sup>7</sup>

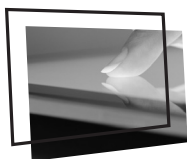
Adopting a sword and shield approach to IPRs and treating them as simple legal assets (if not as obnoxious perils) ensures that a company will lose a great array of value-capturing opportunities. Licensing, cross-licensing, assignments, sales, licensing-back, or securitization are just a few of the tools that can be combined to generate high revenues from IP, expand to other geographical markets and industry sectors, outsource production and commercialization, seal joint development agreements, set global standards, and so forth.

There are many examples of successful IP management. ARM, a semiconductor company founded in Cambridge in 1990, implemented a licensing strategy aimed at developing strong alliances with licensees by tailoring its chip design to their needs and offering constant know-how support. In less than a decade, the company has obtained 77 percent of the worldwide embedded Reduced Instruction Set Computing (RISC) processor market, creating a de facto global technology standard. The same path was more recently followed by Qualcomm and its Code Division Multiple Access (CMDA) technology. Carbon Nanotech (CNI), founded as a startup in Texas in 2000, managed its

patent applications in light of future licensing opportunities and was therefore able, aside from direct manufacturing, to expand into Asian markets and into a multitude of industry sectors. This was done through means of carefully planned cross-licenses and joint development agreements, which were also attractive as they obviously correlate to the high potential and coverage of CNL's portfolio. Many startups opt for the sale-and-license-back of their patents to acquire capital and to inform the external world about the potentialities of their innovation. When an IP portfolio achieves an appropriate size and fame, it can be used as collateral for a loan, or even securitized. David Bowie did just this in 1997 when he issued \$55 million of bonds backed by the next ten years of royalties collected from the sale of its pre-1990 albums.

### Into the Future

During the shift toward a knowledge-based economy, IPRs have gradually assumed an increasing importance. In 1978 the intellectual capital of a company constituted, on average, less than 20 percent of its fixed assets, but a mere ten



The “sword and shield” approach to IPRs leads to losing value-capturing opportunities.

years later the figure would rise to 55 percent, and would continue to rise, reaching 70 percent by 1998. Today, patents, copyright, trademarks, and other analogous rights amount to 75 percent of Fortune 500 firms' value. As

a result, the market for patent licensing has grown from \$15 billion to \$100 billion in a decade. Similar increases characterize the IP litigation/settlement arena, where an astonishing \$1 billion damage award was won by Apple against Samsung in California.

The increased attention paid by the media to these big player fights has ignited interest towards the perils and opportunities offered by the strategic management of intellectual assets. This former “game of kings” is transforming into a much less elitist subject. Today startups and SMEs are increasingly aware of the meaning, implications, and business value of IPRs, and can proactively interact with their counsels to extract value from them.

Such a trend, which originated in the United States, has been spreading in Western Europe. In order to overcome the obstacles engendered by the unresponsive local demand and by the regional path dependence toward secondary innovation, CEE businesses need to look beyond national borders and develop a similar sophistication in their approach to IP if they want to compete successfully in the global marketplace. The time of looking at IPRs as a peril and as a mysterious and expensive legal tool has ended. Today, the double face of Janus can still show CEE business leaders its brilliant side, if only they can develop a new IP culture and master the best practices of strategic IP management.

## NOTES

- <sup>1</sup> Carl Shapiro, "Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard-Setting," in *Innovation Policy and the Economy*, edited by Adam B. Jaffe, Josh Lerner, and Scott Stern (MIT Press, 2001), 120.
- <sup>2</sup> See the concise overview and literature review offered by Marek Tiits et al., "Catching Up, Forging Ahead or Falling Behind? Central and Eastern European Development in 1990–2005," *European Journal of Social Science Research*, vol. 21, no. 1 (2008), 66.
- <sup>3</sup> See EUROSTAT, *Science, Technology and Innovation in Europe* (2010), available at [epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-EM-10-001/EN/KS-EM-10-001-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-EM-10-001/EN/KS-EM-10-001-EN.PDF) (accessed 6 Dec. 2012), 29–34.
- <sup>4</sup> Michael A. Gollin, *Driving Innovation: Intellectual Property Strategy for a Dynamic World* (Cambridge University Press, 2008), 240.
- <sup>5</sup> P. Bernt Hugenholtz and Martin R.F. Senftleben, *Fair Use in Europe. In Search of Flexibility*, Amsterdam, November 2011, available at [www.ivir.nl/publications/hughenholtz/Fair%20Use%20Report%20PUB.pdf](http://www.ivir.nl/publications/hughenholtz/Fair%20Use%20Report%20PUB.pdf) (accessed 6 Dec. 2012), 10.
- <sup>6</sup> In the words of Marshall Phelps and David Kline, *Burning the Ships. Intellectual Property and the Transformation of Microsoft* (Wiley, 2009), 32.
- <sup>7</sup> The PatVal EU Survey on Inventors shows, for example, that while big firms leave 40 percent of the portfolio dormant and trade around 10 percent, in SMEs the latter percentage increase up to 25 percent, with a maximum of less than 20 percent of assets left unused. See Paola Giuri, Myriam Mariani et al., "Inventors and Invention Processes in Europe: Results from the PatVal-EU Survey," *Research Policy*, vol. 36, no. 8 (2007), 1107–1127.







Charles S. Mayer

Chapter 1.5.

# TIME TO FOLD THE TENT: RETAIL RIVALRY IN HUNGARY AND ITS IMPLICATION FOR THE REST OF CEE

## CHAPTER IN BRIEF:

- ❏ The chapter deals with transformation and rivalry of retail chains in Hungary and other Visegrad countries in CEE.
- ❏ Specific attention is paid to Szentendre, a Budapest suburb, which can be seen as a representative CEE microcosm.
- ❏ The overly crowded retail sector of Szentendre highlights the challenges facing the industry in the near future.

If you live in Central and Eastern Europe (CEE), you may have wondered why yet another supermarket, hypermarket, or mall is opening up in a region already well-served by existing stores. I did the same, and the following chapter is the result of my curiosity. This chapter deals with the subject at three levels—at a micro-level in a small region within Hungary, Szentendre (the case study); at the country level for Hungary; and an extrapolation to other CEE countries of the Visegrad Group (Poland, the Czech Republic, and Slovakia).

With the opening of CEE to the West, large multinational retailers moved quickly into the region, targeting the Visegrad Group. The purpose of the alliance was cooperation among countries to further their European integration. All four members of the Visegrad Group became part of the European Union

on 1 May 2004. Some multinationals had entered the Hungarian market before its EU accession. At the end of the 1990s, the Hungarian economy seemed to be slightly ahead of other countries in the region and was more attractive to multinationals. This was particularly true for the extended food retailing sector (fast-moving consumer goods or FMCGs). Hungary, being very central, and having had good economic relations with the West in the past, was one of the more attractive markets to enter. Similar patterns were also true for other Visegrad Group countries, but often on different time frames.

From a marketing point of view, it would be difficult to talk about the CEE market as a whole, as each country in the region is unique. However, some countries are more likely to be at similar stages in their retail development than others. In my opinion, the other Visegrad countries are the ones most likely to be similar to Hungary. I can find support for this position by looking at the A.T. Kearney Global Retail Development Index, which shows that the “window of opportunity” is closing for retailers in Hungary.<sup>1</sup> The proliferation of retail chains depends on various factors, such as macroeconomic, legal, political, and environmental. One of them is the average disposable income. In 2012, the average disposable income in Hungary was €4,884 per capita, the lowest in the alliance, as reported by GfK Group. In the Czech Republic, with nearly the same population as in Hungary (10.5 million inhabitants) the amount was €7,475 per capita, in Poland it was €5,756 per capita, and in Slovakia, as reported by Trade Monitor, the figure was even higher at €10,980 per capita.<sup>2</sup>

Similarities between the CEE markets are thoroughly discussed by other studies featured in this book. The CEE countries are, for instance, similar in terms of innovation (see Chapter 1.2), development of the financial sector (see Chapter 1.3), or prevalence of corruption (see Chapter 1.6). One additional obvious unifying force is the fact that many of the same multinational firms operate in the region. Four or five of the top ten players in each Visegrad country (based on Nielsen AC ranking) are the same: Tesco, Metro (called Macro in Czech), Lidl, Spar, CBA, Auchan, and others. My hypothesis is that the players define the market, as much as the market defines the players.

Casual observation shows that Hungary is over-populated in the extended food retailing sector. Multinational and local chains and smaller players are competing fiercely with each other in a limited market. Hard data supports this observation. The disposable income of Austrian citizens was nearly four times higher than that of Hungarians.<sup>3</sup> Yet, the retail intensity in the FMCG sector in Hungary was, in 2012, at about 60 percent of the Austrian figure.<sup>4</sup> It should be noted that despite this value, retail sales per capita is lower in the CEE region than in developed European countries. The smallest expected growth is in Hungary, where the disposable income adjusted per capita retail space is the highest.<sup>5</sup>

While an in-depth analysis of this phenomenon could be done at the national level, it can be brought into even clearer focus by concentrating on one small microcosm. The one I have selected is Szentendre.

Szentendre

Szentendre is the second most visited tourist destination in Hungary after Budapest. Although this does not affect food shopping, the town is well-known. Szentendre lies on the banks of the Danube, and is twenty-two kilometers north of Budapest.<sup>6</sup> Because its closeness to, and easy access from Budapest, it has become a popular place to live. I chose Szentendre because of noted excessive new store activity. While no one trading area accurately represents the country’s shopping environment, Szentendre is a good representative microcosm.

Figure 1.5.1.

Map of Szentendre with Locations of Retailers

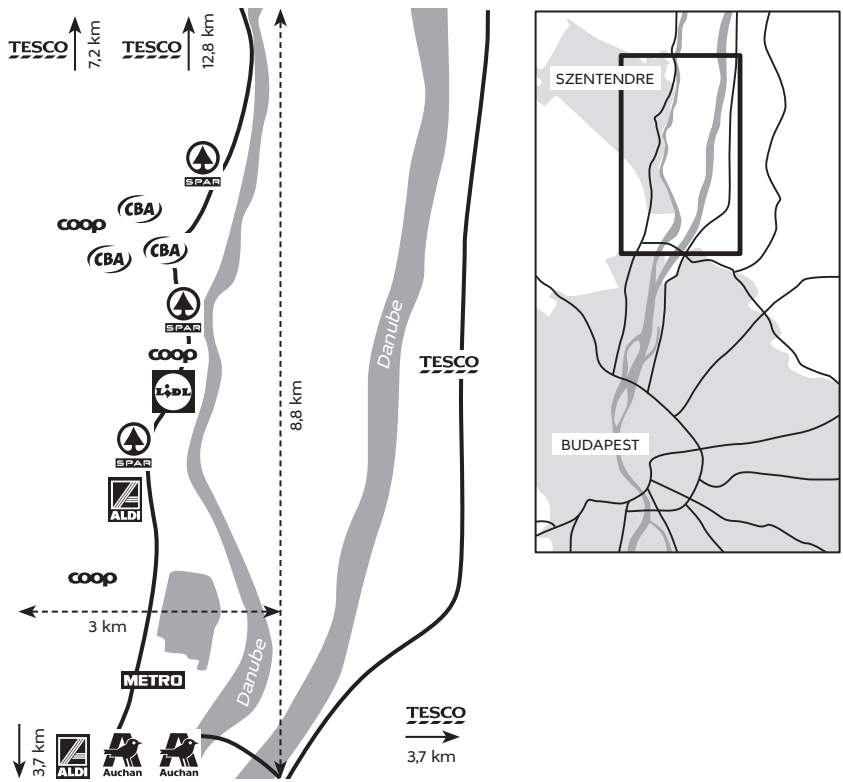
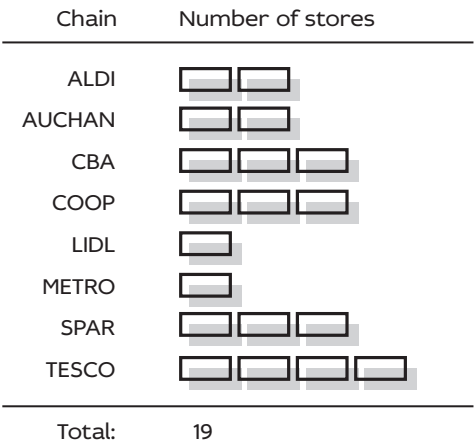


Figure 1.5.2.

Number of Stores in Szentendre and Its Vicinity



In 2011, Szentendre had 25,963 residents. Its population has been constantly growing, increasing by about 16 percent every decade since 1960. Szentendre is also attempting to become a regional service center for a number of adjacent vil- lages, whose population it tends to serve as well. The total population, incorpo- rating these villages, was 75,633 in 2006 and increased to 79,085 in 2010. Off- setting this apparent larger population pool is the fact that on larger shopping trips people in the area tend to shop in close-by Budapest or at other nearby hypermarkets (e.g., Tesco).

As shown in Figure 1.5.1, there are many hypermarkets, supermarkets, gro- cery store chains, and privately owned shops in the Szentendre region. In addi- tion, there are weekly open-air markets. Figure 1.5.2 provides a listing of the major players. There are two Aldi outlets within 2 kilometers of each other, and two large Auchan hypermarkets within 3.7 kilometers of each other. The latter is partially due to the recent acquisition of another hypermarket chain—Cora—by Auchan. Let us now discuss each of the players, along with their market posi- tioning, in greater detail.

### Stores in Szentendre

**Wholesalers: Metro.** Metro Cash & Carry is an international self-service wholesale outlet for SMEs. It is a member of Metro Group, established in 1963 in Germany. The business concept of Metro Cash & Carry is to target B2B cus- tomers in the hotel, restaurant, catering, and retail trade industry. Metro, in 1993, was the first multinational wholesaler to enter the Hungarian market. The chain currently operates thirteen stores in Hungary. Metro opened its stores under the

name Makro in 1994 in Poland and currently operates forty-one units there. In 1997, thirteen Makro stores were opened in the Czech Republic and, in 2000, Metro entered the Slovakian market and currently operates six stores there. Metro is included in my list because it is relevant for business entities, which are very easy to establish in Hungary and are usually established for tax purposes. Thus, shopping for personal consumption at Metro stores is not uncommon.

**Discounters: Lidl.** Lidl is a European discount supermarket chain of German origin that belongs to the holding company Schwarz Gruppe. Lidl entered Hungary as the first hard-discount chain, opening twenty-one stores in 2004. During the first six months of its operation, Lidl reached nearly 29 percent of the households. In eight years, the number of stores increased rapidly and in 2012 Lidl operated 156 stores, 25 of them in Budapest. Lidl, as a hard-discount chain, sells groceries and miscellaneous items mainly under its own brand name, which contains between 800 and 1,000 items. In 2011, Lidl earned €840.2 million in Hungary.

**Discounters: Aldi.** Aldi, another German company, is Lidl's most important competitor. It entered the Hungarian market four years after Lidl, opening nine stores simultaneously. The company was founded in 1913 in Germany by two brothers—and was later split in two: Aldi Nord and AldiSüd. The Hungarian affiliate belongs to Aldi Süd that has 4,425 stores worldwide<sup>7</sup> and 86<sup>8</sup> in Hungary. The Hungarian operation generated €247.1 million in revenue in 2011. Similarly to Lidl, Aldi offers to its customers a limited range of private label products at competitive discount prices.

**Hypermarkets: Auchan.** Groupe Auchan SA is a French international retail chain with presence in twelve countries. As of 2011 it was operating 639 hypermarkets and 2,412 supermarkets around the world. In Hungary, its first hypermarket was opened in 1998. On October 30, 2012, Auchan acquired seven Cora hypermarkets in Hungary, increasing the number of Auchan hypermarkets to nineteen. The acquisition cost was €20.6 million<sup>9</sup> and it took six month to complete. Auchan purchased not only real estate, but also the know-how relating to all the services Cora offered, which were preserved due to popularity among customers. The strategic question was how to mitigate the loss of customers due to the closeness of some Auchan hypermarkets to the previous Cora stores. In order to avoid cannibalization, Auchan plans to focus its outlets on different market segments and each hypermarket has unique offerings. The sum of the revenue realized by Auchan (€824 million) and Cora (€308 million) in 2011 is still below that of Tesco (€2,526 million).

**Hypermarkets: Tesco.** There are no Tesco hypermarkets in the Szentendre area, but there are at least four of them outside of Budapest, which is sufficiently close to attract shoppers from the Szentendre area. These shoppers will go there only for larger shopping trips. Tesco PLC is a British multinational grocery and general merchandise retailer founded in 1919. Hungary was the first international business of the chain, which entered the market in 1995 through the

acquisition of twenty-six stores owned by the retailer S-Market's in the North-West of Hungary. Its first hypermarket in Budapest was opened in 1996. Tesco entered the market aggressively and penetrated it with a strong store presence not only in cities but also in rural areas. Tesco was the first chain to introduce twenty-four-hour shopping and the first one to introduce private labels. In 2012, Tesco operated 213 stores in Hungary employing 22,000 people, making it the fourth largest employer in the country.<sup>10</sup> Tesco has further expansion plans. As a consistent market leader, Tesco generates the highest revenue among all retail chains in Hungary and was one of the few companies in the sector that increased revenue during the economic crisis. Tesco offers not only grocery products but a wide range of goods, like clothing or mobile phone services. Individual stores are also diversified. Four categories exist: hypermarkets, supermarkets, express, and S-Market. They differ in size from a few hundred square meters to thousands square meters. Tesco is interested in investing in small shops, not only in Hungary but also in Poland. The multinational hypermarket is interested in Polish cities with populations under 5,000 inhabitants and will offer wider product ranges than discount retailers (4,000–6,000 products).<sup>11</sup>

**Purchasing Cooperatives: CBA.** In 1992, ten private Hungarian businessmen joined to buy seventeen Hungarian state-owned food stores. As a result of successful cooperation the CBA-food chain was born, which has been 100 percent Hungarian-owned since its foundation. In 1995, CBA established its own 2,000-square-meter warehouse with the aim to increase storage capacity and also broaden the scope of its customer service department. Due to the higher order quantities of joint procurement of CBA members, the prices decreased throughout its stores, creating competitive advantage for the chain. Eighty percent of CBA shops operate outside of Budapest. In 2000, they began a joint partnership with German EDEKA, Europe's largest trading association; however, CBA did not expand into Germany. The aim of partnership with EDEKA was to learn the know-how of developing an internationally effective franchise system.<sup>12</sup> This strategic move, helped to drive the Hungarian chain's international expansion a year later. In 2001, CBA entered the Croatian market<sup>13</sup> and in 2005 it built a state-of-the-art logistics center that changed the character of operation. CBA has become an internationally expanding franchise system. In 2009, CBA diversified its stores by opening high quality shops under CBA Prima name and soft discounters called CBA Cent. Based on Nielsen reports, CBA was the second largest retail chain after Tesco in 2011, generating €2,024 million in revenue. It operates more than 3,383 store outlets and its business model is expanding to such countries as Bulgaria, the Czech Republic, Croatia, Poland, Lithuania, Romania, Serbia, Slovakia, and Slovenia.

**Purchasing Cooperatives: Coop.** CBA's biggest competitor is Coop,<sup>14</sup> which operates more than 3,000 shops in 1,650 municipalities in 2012. Coop group was established in 1995, three years after the launch of CBA. Over 600 shops belonged to the group in the first year of its operation and, since its expansion

into the countryside, the network has since grown rapidly, tripling by 1999. In 2000, Coop expanded its network into Slovakia and the Czech Republic. In 2011, the franchises generated €1,827 million in revenue.<sup>15</sup> The shops are grouped by size and the smallest ones are called Mini Coop (under 200 m<sup>2</sup>). Larger shops are classified as follows: Coop (200–300 m<sup>2</sup>), ABC Coop (300–600 m<sup>2</sup>) and Super Coop (600–900 m<sup>2</sup>).

**Supermarkets: SPAR.** The SPAR was founded in 1932 in the Netherlands as a large, self-organized, retail chain association. The aim of cooperation was to operate more efficiently by combining purchasing power when placing orders. The business model spread rapidly throughout Europe in the 1950s. Currently, the supermarket chain operates in thirty-three countries on five continents, incorporating more than 15,000 stores of various sizes, occupying about 6 million square meters of sales space. The majority of SPAR stores are independently owned and operated. SPAR was set up in Hungary in 1990 by the Austrian ASPIAG (Austria SPAR International AG) group based in Switzerland. Spar later acquired seven large-scale supermarkets in Budapest. Around 200 existing locations were taken over and redesigned by SPAR in the next few years. Takeovers were the main tool of expansion tactics. Important steps were the acquisition of fourteen Billa shops in 2002 and twenty-two Kaiser supermarkets in 2003. SPAR joined a purchasing cooperative with Metro and Praktiker, called METSPA. In the cooperation agreement, merchandising ventures become interlinked and supplier partnerships are agreed upon. SPAR in Hungary consistently holds fourth place on the Nielsen list, following Tesco, CBA, and Coop. SPAR uses four main store formats in every country.<sup>16</sup> The core SPAR is a traditional supermarket, INTERSPAR is a bigger size hypermarket and EURO-SPAR is the largest format, occupying more than 1,000 square meters. The smallest format is SPAR Express, a convenience store with extended opening hours. In 2009, SPAR operated 398 stores in Hungary. In 2012, the company decided to launch a franchise system in Hungary; the first SPAR partner joined under the new structure in September 2012.<sup>17</sup>

**Chains Leaving Hungarian Market: Cora, Match, Profi.** With all the retail rivalry, it was anticipated that a number of chains would leave Hungary, especially after the financial crisis. Such departures only emphasize the thesis that is being put forward: there are too many FMCG stores in Hungary. The Belgian-based Louis Delhaize group has operations in France, Luxembourg, Belgium, Romania and, until the end of 2012, had stores in Hungary. In 2011, the group had an annual turnover of €11 billion and had more than 50,000 employees. In 2012, the management decided to leave the Hungarian market with all its brands, Cora, Match, and Profi. Match stores were higher quality supermarkets and Profi was a discounter. The turnover of Match decreased from €196 million to €148 million between 2009 and 2011 and Profi performed poorly as well, as its revenue stagnated around €100 million in 2011. The group's seven Cora hypermarkets were acquired by Auchan in 2012 and 110 Match and Profi

stores (stores occupying between 300 and 2,500 square meters of retail space) were sold to CBA in Budapest and to Coop in rural areas. Starting in November 2012, CBA took over forty-eight and Coop acquired sixty-two. On June 4, 2013, after renovations, the former Match stores opened in Budapest under the CBA brand. In Hungary, the competition is strong, with many acquisitions being observed. This process is also expected in other Visegrad countries. Based on the Nielsen report, the competition will soon increase in Poland and the consolidation and acquisitions process are expected to begin.

### The Rivalry

Product lines of discounters are becoming more homogeneous in every product category and there are only a few products that are unique to a particular discount chain.<sup>18</sup> The advantage of CBA and Coop in comparison with the discounters is that they are purchasing from local producers and in this way they can offer a more diversified and wider product range. Both CBA and Coop position themselves as buy local, Hungarian-owned chains. CBA is engaged in CSR activities like supporting Hungarian arts or giving food to poor children through donations.<sup>19</sup> Lidl started a new communication campaign in 2012, emphasizing the importance of Hungarian suppliers, and increasing the percentage of Hungarian products in its stores.<sup>20</sup> Similar to Hungary, the number of discounters in the Czech Republic is also high. They try to attract customers by being more active in promotional activities and offering special prices. Further, they have introduced loyalty programs and launched private label products. In order to be competitive, they have broadened their product lines and modernized shopping environments. Although the same tendencies are observable in Hungary, because of the higher purchasing power of Czech customers, there is a higher growth rate expected in the Czech Republic.<sup>21</sup> Some growth is expected in Slovakia, but at a lower rate. FMCG retailers expect growth in Poland, but even the most positive views about their future also predict some difficulties.

In Hungary, during 2011 and 2012, there were no significant changes in the market shares of store types. In 2011, the number of general food stores was 19,569 and the next year the number of stores decreased to 19,544.<sup>22</sup> In 2012, the number of hypermarkets increased by 4 to 170, discounters increased by 21 to 488, and supermarkets increased by 7 to 574.

CBA has a stronger position in Budapest and urban areas while Coop has more shops in the countryside. In contrast to the previous dynamic expansion, CBA currently makes a market analysis before accepting an application from a new franchise partner. In regions where many small shops are geographically close to each other it is questionable if a new franchise partner will be able to generate profit. CBA's communications director explained that the company's success, in contrast to the discounters, is in its product range. CBA focuses on local needs and is able to offer special local products. The supermarkets, on average, serve the daily purchasing needs of people. Because of the high level of com-



petition and decreasing purchasing power, CBA tries to cater to specific customer segments. CBA Prima shops offer high quality products at a higher price and its Cent retailers offer lower quality products at very low prices and have a product range twice as large as discounters (approximately 4,000 items instead of 2,000).

The combined revenue of the thirteen chains operating in Hungary (those that have no representation in Szentendre were not mentioned in this chapter) was €10,482 million<sup>23</sup> in 2011 and is currently in the state of stagnation.<sup>24</sup> Tesco, CBA, and Coop are market leaders, Aldi and Lidl are growing fast, but the mar-



Retail intensity in CEE is higher than in many developed countries.

ket is not profitable for all players. The sector generated losses between 2009 and 2012. In 2009 the loss was €47.3 million,<sup>25</sup> which increased to €69 million in 2011. The change is significant even if we calculate with the non-real-

ized profit caused by the rapid depreciation of the Hungarian forint (€66.5 million<sup>26</sup> between 2009 and 2012). In Slovakia, the largest retailer is Tesco Stores SR AS, which held nearly 11 percent of the market in 2011. The second biggest retailer was COOP Jednota Slovensko SD with a 10 percent share.<sup>27</sup>

Analyzing the cost structure of companies, there are four elements that have the highest impact on profitability, including cost of goods, purchased services, materials, and labor costs. In the case of the four chains out of ten, these costs are higher than sales revenue and two are very close to 100 percent. There are only two discount chains that can report profit improvement—Aldi and Lidl, as well as one hypermarket—Tesco. Overall, the financial performance of chains in Hungary is stagnant, or weak.

### Will Only the Fittest Survive?

Store overpopulation and extreme competition in the extended food retail industry exists in Szentendre and many other Hungarian towns and cities. The retail space per capita is lower in Visegrad countries than the European average and most developed European countries. But in comparison with disposable income, the retail intensity seems to be higher than in Austria or some other developed countries. Indeed, as noted in the introduction to this chapter, similar trends can be observed throughout CEE. They cannot be explained by population size, or by growing disposable income. What other explanations are possible?

CEE in general, and Hungary in particular, was seen as a strategic market by several large multinational chains. Staying out of the market had significant implications. The late entry of Aldi into an already saturated market is a case in point. However, with the impact of the financial crisis, and the changing role of CEE in the portfolio of multinational chains, this market may no longer be as attractive. The consumer clearly benefits from this rivalry. Already low prices are continually eroded by “special sales,” further reducing the profit margins. While not proven, low prices might also result in lower (hidden) quality.



CEE was seen as a strategic market by several multinational chains.

Unable to compete, many mom and pop shops had no choice but to close. The number of small independent stores has reduced substantially during the past ten years. An alternative for small stores was to band together in cooperatives, such as CBA and Coop. This enabled them to stay competitive in terms of price. This business model seems to be working, and its success is being exported to other markets. The battle for market share is not over yet. As seen in the example of Cora and Auchan, Kaiser and Spar, and now Match and CBA/Coop, further mergers and acquisitions are likely in the future.

My curiosity as to why there are so many competing stores in a trading area has been ratified by M&A activities during my study. Mergers and acquisitions, however, are about ownership, not number of outlets. The M&A activity will lead eventually to the closing of several outlets in an effort to reduce square meters devoted to this sector. If this happens, it could lead to the loss of major anchors in malls, increasing pressure on malls to close. In the long-term, local suppliers will become more open to regional competition, and hence feel pressures on their margins and demand for their products. The only winners in the rivalry will be a few players, who can become dominant. Of course, domination is established not only through price, but also through location, product offerings, quality, service levels, and convenience. I predict that a lot of red ink will flow before some market equilibrium can be established.

### Acknowledgments

The writer wishes to acknowledge the contribution of Dóra Ágnes Berend, MBA to the research leading up to the writing of this chapter.

### NOTES

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<sup>5</sup> Available at [www.youtube.com/watch?v=SRQb91SMtIw](http://www.youtube.com/watch?v=SRQb91SMtIw) (accessed 27 Jan. 2013).

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- <sup>18</sup> Available at [www.elelmiszer.hu/friss\\_hirek/cikk/a\\_diszkontok\\_fokent\\_a\\_hipermarketekkel\\_versenyeznek](http://www.elelmiszer.hu/friss_hirek/cikk/a_diszkontok_fokent_a_hipermarketekkel_versenyeznek) (accessed 22 Oct. 2012).
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- <sup>23</sup> Calculated by using historical mid-market rates (HUF/EUR), [www.xe.com](http://www.xe.com).
- <sup>24</sup> Available at [www.elelmiszer.hu/tesco/cikk/milyen\\_volt\\_a\\_kereskedelmi\\_lancok\\_2011\\_es\\_eve](http://www.elelmiszer.hu/tesco/cikk/milyen_volt_a_kereskedelmi_lancok_2011_es_eve) (accessed 22 Nov. 2012).
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Yusaf H. Akbar *and* Vukan Vujic

Chapter 1.6.

# CORRUPTION IN CENTRAL AND EAST EUROPE: ECONOMICS, POLITICS, AND CULTURAL VALUES

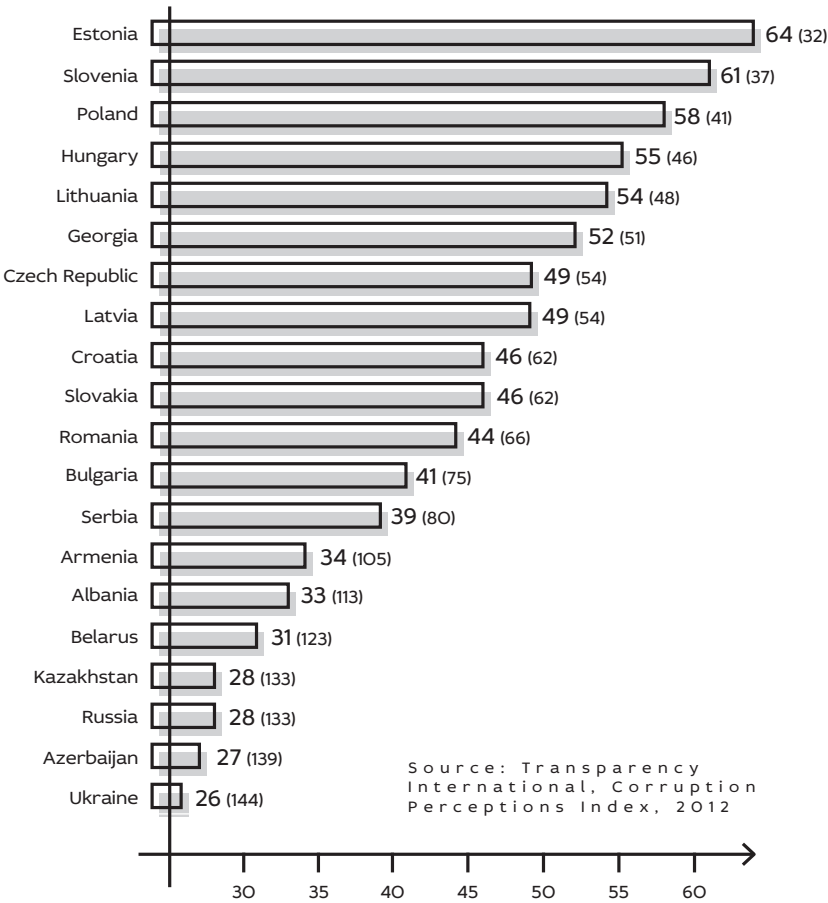
## CHAPTER IN BRIEF:

- ❏ In CEE, middle-to-high level corruption has persisted for many years.
- ❏ Economic variables such as GDP, size of government expenditure, and the level of foreign direct investment are the greatest predictors of corruption.
- ❏ Economics alone cannot explain corruption; national cultural values must also be taken into consideration.

Interest in corruption research has grown in importance in recent years in response to several related factors. First, there has been a heightened focus by governments and public policymakers on the negative impact of corruption on economic performance and societal welfare. Corruption is believed to lead to slower economic growth characterized by a more unequal distribution of its associated gains. Second, corporate strategists and executive-level decision makers have made conscious efforts to incorporate corporate social responsibility into their organization's mission and operations in a systematic and more far-reaching way than in the past. Third, as the global reach of multinational companies from developed countries has intensified in the past twenty-five years in the so-called emerging markets, companies and managers

are now operating in market environments that are more likely to be prone to corruption (as illustrated by Transparency International's Corruption Perceptions Index or the World Bank's Worldwide Governance Indicators). Recent high-profile scandals involving Siemens Corporation, PricewaterhouseCoopers and others, have been emblematic of this new reality. Fourth, corruption is believed to lead to a concentration of political power in the hands of a few wealthy people. The key point is that virtually nobody is immune from the impact of corruption today. Trying to identify and disentangle the causes

**Figure 1.6.1.**  
2012 Corruption Perceptions Index for Selected CEE Countries  
Score out of 100 (Rank in Parentheses)



of corruption is therefore an important task for researchers and policymakers around the world.

In 1989, when the countries of Central and East Europe (CEE) embarked on a process of economic, political, and social transition away from the varied levels of centralized planning that they experienced prior to 1989, few would have predicted that corruption would become such a source of profound concern for these societies, nor that it would be so prevalent. This is due to two factors. First, there was no serious published research on the nature of corruption that existed in these societies during the socialist period.<sup>1</sup> Because there was no official recognition of a corruption problem, the



Looking back, the naive nature of the big bang approach to transition is stunning.

pre-existing nature of corruption has received little attention. Second, once the period of transition began, prominent and influential thinkers in the West made an optimistic assumption

that the creation of free markets would lead to an efficient allocation of resources that would root out corruption (since they assumed corruption is, by definition, an inefficient activity). Jeffrey Sachs's big bang approach to transition became widely accepted by Western policymakers. Looking back, the unbelievably naive nature of this idea is stunning.

Thus, we argue that, although officially unrecognized, corruption was widespread before the 1989 revolutions and was further intensified by the transition process itself. The question then becomes: What aspects of the transition process exacerbated the corruption problems in CEE countries? We argue that there are two factors that can help us find the answer: cultural and economic. In this chapter we provide an analysis of both these factors. We also explain what it all means for policymakers and managers.

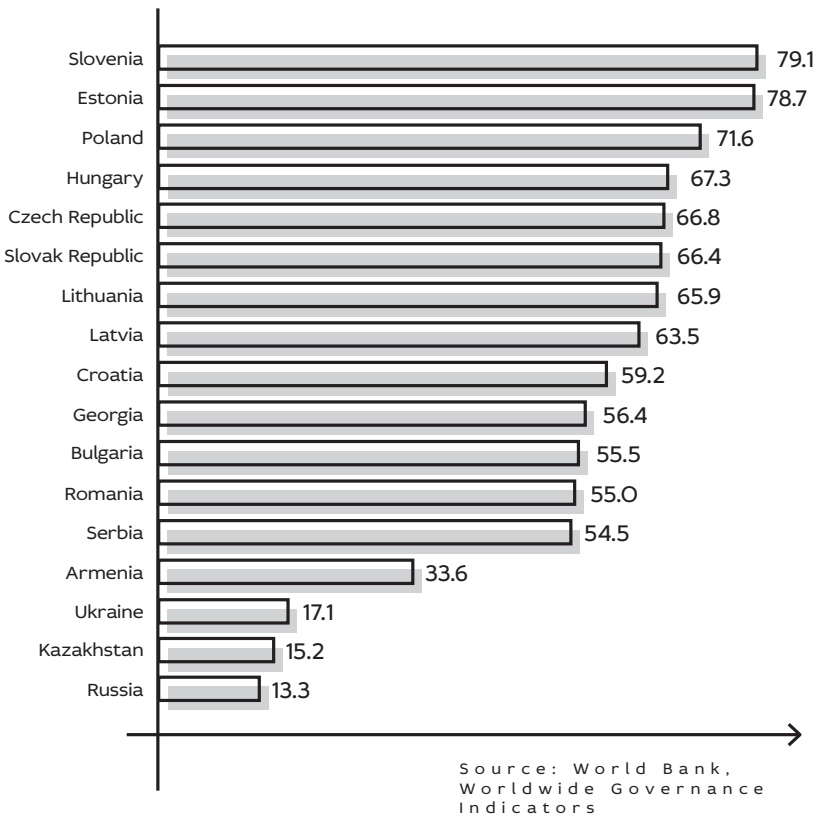
### The Nature of Corruption in CEE

The 2012 Transparency International Corruption Perceptions Index (CPI) reported that the highest ranked CEE country was Estonia (thirty-second place) behind other countries such as Barbados (fifteenth), Qatar (twenty-seventh), and Botswana (thirtieth). The next CEE country was Slovenia in thirty-seventh place and the lowest was Ukraine, which came in at 144 of 176 countries surveyed (see Figure 1.6.1).

There is a substantial variance among the CEE economies, with former Soviet republics—with the exception of Estonia, Latvia, and Lithuania—performing much worse than member states of the European Union. While the intra-CEE rankings may vary from year to year—for example, in 2011, Estonia ranked twenty-ninth and Slovenia thirty-fifth, yet both fell in 2012—there is a consistent middle-to-high level of corruption that has persisted for many years.

Figure 1.6.2 shows the Control of Corruption Index of the World Bank's Worldwide Governance Indicators for 2011. It paints a very similar picture of the CEE

**Figure 1.6.2.**  
Control of Corruption Index 2011 for Selected CEE Countries  
Score out of 100



region with regard to corruption. This index is measured as perceptions of the degree to which public power is exploited for private benefit, including all types of corruption, as well as “regulatory capture” of the state by elites and concentrated private interests. It draws on all sectors of society (households, businesses, NGOs, and the government). Estonia and Slovenia rank strongest on the control of corruption whereas Russia and Ukraine appear to be governed by vested interests.

**Explaining Corruption: Economic and Cultural Factors**

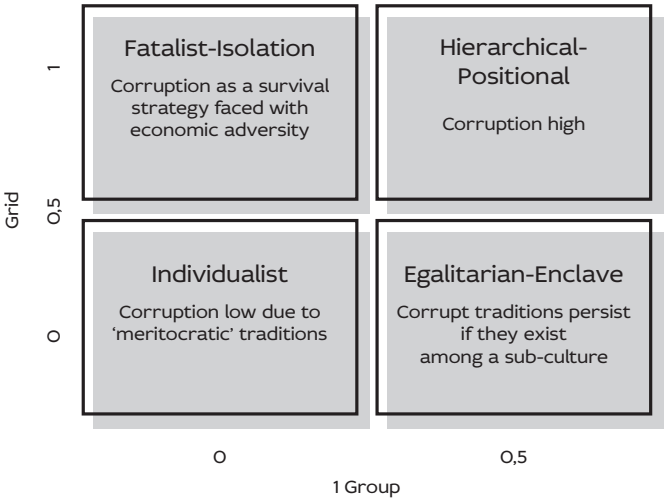
Because it is empirically demonstrated that CEE has medium to high levels of corruption, it is worthwhile to explore both why corruption exists and why it persists. A multivariate analysis seeking to explain the causes of corruption (as part of a forthcoming broader study on corruption) has been carried out. More than fifty countries were used in the analysis. The sample countries covered all



major continents, varying levels of economic development and diverse histories. Partly based on previous research, we posited that several parameters would be the most influential. First, economic variables such as GDP, size of government expenditure, and level of foreign direct investment (FDI) were considered. Richer countries are expected to have lower levels of corruption, countries where government expenditures account for larger proportions of the GDP are expected to have higher corruption as bureaucrats have more capital to siphon off for vested interests, and countries with larger FDI are expected to have lower levels of corruption due to increased transparency and openness in the economy. More controversially, we argued that national cultural values could also influence the level of corruption in a country. In the study, we used a model of culture first developed by anthropologist Mary Douglas.<sup>2</sup>

In Douglas’s framework, it is argued that two dimensions of culture defined a society. The first one is the concept of *grid*, which measures the amount of hierarchical control that group members are willing to accept. At one extreme, a society that has weak grid characteristics is one where no hierarchy is present; there are no structural or formal constraints on an individual’s behavior. At the other extreme, societies with strong grid characteristics displaying complete hierarchical control, individuals are completely locked into institutionally

Figure 1.6.3.  
Corruption Propensities and Group-Grid



Source: Mary Douglas, *Natural Symbols: Exploration in Cosmology* (Pantheon Books, 1970)

defined actions. This is similar to Geert Hofstede's famous "power distance" measure, which examines the extent to which people accept the unequal distribution of power in society. Douglas also considered *group*, which describes the extent to which a person's life is conditioned and constrained by the group to which he belongs. Through group participation, individuals agree to constraints on their behavior through societally accepted norms and behaviors. This can take strong expressions such as joining a religious cult or much weaker ones such as membership in private associations, for example, a golf club. When combined, the group-grid dimensions, measured on a scale from 0 to 1, produce 4 quadrants, or distinct cultures (or forms of social control) as illustrated in Figure 1.6.3. The figure also presents expected relationships with various manifestations of corruption.

**Hierarchical-Positional** cultures have strong grid and group characteristics (upper-right quadrant). They are exemplified by a society in which most or all roles are ascribed, most or all behavior is governed by positional rules and all the constituent groups are contained within a comprehensive larger group. Tradition and order are characteristic feature of these societies. Collective decision making is the hallmark for problem solving in these cultures and roles are assigned by inscriptive values such as age, family, and ethnicity.

**Egalitarian-Enclave** cultures have strong group and weak grid characteristics (bottom-right quadrant). These societies tend to seek egalitarianism because they typically reject inequalities that naturally occur. Idealistically, it is very difficult to organize an egalitarian community and the pursuit of equality can result in a culture handicapped by problems of leadership, authority, and decision making.

**Individualistic** cultures, by definition, have both weak grid and group characteristics (bottom-left quadrant). Competition is the dominant form of social and economic interaction. These societies see themselves as inherently meritocratic and, paradoxically, while believing that competition is an objective arbiter of outcomes, the outcomes themselves lead to concentrations of power and wealth because of the inherent winner-loser characteristic of competition.

**Fatalist-Isolated** culture has both strong grid and weak group characteristics (upper-left quadrant). People in these cultures have low group orientation but demonstrate high levels of hierarchical control. They display apathy and prefer static non-changing environments. They are skeptical about the role that individuals can play in changing whole societies and cultures, yet prefer to be left alone to pursue their own limited goals of survival and self-reliance.

Using these pre-existing measures, which characterize cultures in terms of grid and group orientations, Chai et al. analyzed and categorized many countries.<sup>3</sup> The grid and group values used in our analysis come from Chai and colleagues' work. Our findings have proved significant; using a multi-factor quantitative model, which included economic control variables such as GDP per capita, FDI, and government spending, we uncovered robust and statistically significant relationships. Our three expected outcomes were confirmed. In addi-

tion, hierarchical-positional (strong grid, strong group) and fatalist-isolationist (strong grid, weak group) cultures were positively correlated with corruption whereas egalitarian-enclave (weak grid, strong group) cultures correlated with lower corruption. Overall, the quantitative model, where all cultural, economic, and political factors are considered, demonstrates statistical significance.

**Implications for CEE**

The results of our broader study covered fifty countries and more than one-third of the sample countries are those from CEE and the Commonwealth of Independent States (CIS) (about twenty countries altogether). Classifying the CEE countries using Douglas’s framework, Albania, Bosnia, Moldova, Poland, Romania, and Serbia showed to have strong grid characteristics. Hierarchical cultures include Belarus, Georgia, Kyrgyzstan, Macedonia, Russia, and Ukraine. Fatalistic cultures are Azerbaijan, Czech Republic, Hungary, Latvia, Lithuania, and Slovakia. The only egalitarian culture is Estonia. Slovenia was the closest to being an Individualist culture (with group and grid scores recorded at 0.45). Of note on a descriptive level (with the exception of Estonia and Slovenia) is that all countries from CEE had medium to high levels of perceived corruption, scoring less than six out of ten on the CPI (where higher scores mean lower levels of perceived corruption). Estonia, with a score of 6.7, was the only country with low levels of perceived corruption. Moreover, some countries with higher GDP per capita (Czech Republic), higher FDI (Georgia), and lower government spending (Albania), when compared to Estonia, still have higher levels of perceived corruption. This suggests that economics alone cannot explain corruption. Among the group of twenty countries from CEE, using Estonia as a benchmark, egalitarian cultures have lower levels of perceived corruption compared to hierarchical and fatalistic cultures.

Clearly, we could consider Douglas’s cultural classification as a way of segmenting the CEE group; most EU member states have lower levels of perceived corruption than non-EU member states (although Romania and Bulgaria do not have significantly higher CPI scores).

**Implications for Managers and Public Policy**

Our study suggests important conclusions for management and public policy. Managers operating in fatalistic and hierarchical cultures need to be cognizant



Institutional reforms must break down hierarchies and promote accountability.

of the fact that in order to operate effectively they must confront corruption, either by working with public officials or through motivating fellow managers. Strengthening whistleblower processes in these cultures will be an

important tactical weapon in fighting corruption—a fact also mentioned by Noémi Alexa in Chapter 1.8 of this volume. Multinational companies, who have

progressively phased out expatriate managers in their subsidiaries and replaced them with local managers, need to invest in training these managers to combat cultural responses to corrupt behavior.

Public policy, in turn, must relentlessly focus on institutional reform, breaking down hierarchies, and promoting greater efficiency, transparency, and accountability. Working with the private sector, especially multinational companies, public policy should aim to challenge cultural values associated with hierarchy and fatalism; this will be crucial to curbing corruption in these cultures. This is a broad and far-reaching target that has to be tackled at all levels of society. Policymakers should develop strategies closely with the private sector as well as nongovernmental organizations to develop anti-corruption education and training programs for both public and private sector managers. With all that being said, the expectations we form as to the scope and extent of a possible policy response must take into account limited capacity of governments to promote socially responsible corporate behavior—and, in particular, to combat corruption—as is discussed by Peter Hardi and Noémi Alexa in the next two chapters.

## NOTES

- <sup>1</sup> An exception was Viktor Zaslavsky's 1982 ethnographic study, *The Neo-Stalinist State: Class, Ethnicity, and Consensus in Soviet Society* (M. E. Sharpe, 1982). Of course the book was never published in the USSR. It was published in the West when Zaslavsky became an émigré.
- <sup>2</sup> Mary Douglas, *Natural Symbols: Explorations in Cosmology* (Pantheon Books, 1970).
- <sup>3</sup> Sun-Ki Chai, Ming Liu, and Min-Sun Kim, "Cultural Comparisons of Beliefs and Values: Applying the Grid-Group Approach to the World Values Survey," *Beliefs and Values*, vol. 1, no. 2 (2009), 193–208.



Peter Hardi

Chapter 1.7.

# CORPORATE SOCIAL RESPONSIBILITY IN ECONOMIES OF TRANSITION: THE ROLE OF THE STATE

## CHAPTER IN BRIEF:

- ▣ In transition economies, the state has no effective public policy tools to promote CSR.
- ▣ The European Commission's evolving definition of CSR reflects a tendency to consider CSR as a tool for wealth redistribution.
- ▣ The trend to make CSR mandatory is a response to the failure of the state to provide expected social services.

Over the past decade the interpretation of corporate social responsibility (CSR) has evolved through important changes. In the micro-environment of firms, CSR has become more generally accepted and in several cases it has been incorporated as a regular feature of company strategy. In the macro-environment of social actors, particularly within governments, CSR has been reinterpreted as a necessary requirement of corporate strategy rather than a voluntary activity of individual firms. I analyze these changes through the firm-state relationship and illustrate their effects from the specific perspective of economies in transition.

## CSR in Transition Economies

The social perception of CSR in transition economies is strongly influenced by what has been inherited from communism. State-owned corporations became the providers of many of the state's former functions. Social services (such as nurseries, day cares, medical services, support for art clubs, sport clubs) were provided by these state-owned companies, creating the illusion that such services were actually provided by the firms, and not by the owner, that is the state. Public expectations for the continuation of such services have survived and have become a source of pressure on the companies to maintain them under the CSR banner. It is a similar function to that of a social enterprise in achieving social good, as it is shown by Noémi Alexa's in the next chapter. CSR has an additional and unintended role in providing social good beyond immediate business related impacts: As Yusaf Akbar and Vukan Vujic observe in the previous chapter, it is one of the reasons why higher attention has been paid to corruption in Central and Eastern Europe (CEE). My empirical research suggests that this model still remains attractive for the state and community groups in a new market setting. I illustrate this point with a case from Hungary.<sup>1</sup>

In the winter of 2009/10, many Hungarian families suffered from cold weather conditions; a substantial number of people died because their homes had no heat. Under normal circumstances one of Hungary's major utility companies would discontinue service for customers who failed to pay their bills for ninety days. Though the company introduced several methods to ease the payment, it worried that it had not done enough to secure the safety of citizens during cold winter days. The firm's Corporate Responsibility Management Circle decided that the company should make every effort to prevent the deaths of customers and announced that it would not discontinue service to non-paying customers during periods of extreme cold weather. This Cold Winter Days Program was the firm's most visible CSR activity. It was a program that dealt with the firm's core activity (providing utility service) and emphasized the firm's strategy to address social priorities (protecting vulnerable customers). It, however, compromised company profits. In addition, it was not strictly a CSR activity but rather an altruistic program as it did not address any adverse consequences of the firm's operation; neither the extreme cold weather nor the inability of certain customers to pay their bill was a consequence of the firm's activities.

In reaction to severe weather and deaths during that winter, the Hungarian government introduced a new regulation. Inspired by the positive media attention generated by the company's program and in order to protect all citizens, energy suppliers were banned from discontinuing services to households between October 15 and April 15, regardless of the temperature. This regulation was introduced shortly after the utility company had announced its Cold Winter Days Program. According to company officials, the government, faced with approaching national elections, likely passed this popular resolution in the hope that it would boost its dismally low approval ratings.



The new regulation, however, was highly restrictive, placing energy suppliers at a disadvantage. Previously they had the flexibility to make decisions that affected their customers. For example, they could define which days were too cold to discontinue service, whose contract they would terminate, on what terms and conditions, and for how long. In addition, the period prescribed in the regulation was extremely long: five months during the peak period of energy consumption, and the regulation protected all consumers, not only vulnerable ones. It did not differentiate between economically depressed customers who really needed support and average households that had the ability to pay their bills. All energy utility companies faced huge revenue losses as a consequence of this rash action; after introducing the new government regulation customer debt increased by 20 percent. The state's actions were perceived as a step to make a CSR program, voluntarily invented by a firm, mandatory, thus depriving firms of flexibility in addressing social issues through their own strategies.

This case illustrates how government solutions to social problems can come at the expense of corporations. Unfortunately, this government-mandated approach to CSR has become engrained in the tax policy of certain governments (further exemplified by the Hungarian Robin Hood tax on gas and electricity utility companies).<sup>2</sup> It highlights a more general tendency of state intervention in business in CEE: After the initial enthusiasm for a liberal market capitalism, the state has gradually become more important player—both in a positive way illustrated, for instance by the JEREMIE program (see Chapter 1.3); and in a negative fashion, such as when public officials interfere in managerial decision making by preventing migration of production capacities (see Chapter 1.2).

For the CEE countries in transition, CSR has not been embedded in national institutions. Government policy after the financial crisis in the late



2000s tended to be prescriptive. Instead of mobilizing government policy tools in support of a desired CSR policy, the government relied on corporate resources in fulfilling its own social responsibility and CSR is considered a complement to public policy.

There seems to be a convergence between developed and transition economies with regard to the role that businesses play in solving social problems the state cannot. The intentions of the Hungarian government and of the European Commission (EC), as per its newly defined definition of CSR, seem to point in the same direction: Corporations should more actively address pressing social problems (i.e., beyond just paying regular corporate taxes) that the state is no longer able to solve. The E.on case also demonstrates that while CEE lags behind the West in many business fields, as it is shown in the reference to replicators versus innovators in Chapter 1.4, a company can be an innovator in the field of CSR while the state takes up the role of a replicator.

There are, however, important differences between the role of the state in influencing CSR in the developed and in transition economies of the EU. One difference is that the EC and member states of developed countries introduced several public policy tools to promote CSR. These were introduced based on the perception that the costs of externalities related to business activities (producing and providing goods and services) should not be borne by the whole society but, at least partially, by those who are responsible for creating them. To better understand the differences, it is necessary to briefly analyze the evolution of the definition of CSR and its policy implications within the EC.

### **Changing CSR Definition in the European Commission**

In 2001, the EC defined CSR as “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.”<sup>3</sup> In October 2011, the EC published its new interpretation of CSR:

CSR . . . [is] the responsibility of enterprises for their impacts on society . . . To fully meet their social responsibility, enterprises should have in place a process to integrate social, environmental, ethical and human rights concerns into their business operations and core strategy . . . with the aim of . . . identifying, preventing and mitigating their possible adverse impacts.<sup>4</sup>

The 2001 definition reflected the general assumption held by business actors and other social groups, including state actors, that CSR is a voluntary add-on to regular market activities and legal compliance of companies. In other words, CSR was considered an independent management approach. Indeed, some companies opted for voluntary actions, which became known as CSR, to respond to external pressures by social groups, NGOs, media and governmental institutions concern-



ing non-market issues that may be associated with the firm's market activities. Externalities included social and environmental areas where "adverse impacts" would otherwise be ignored and unchecked. The central controversy around CSR



CSR is considered a complement to public policy.

actions has long been related to their financial implications; as these actions come with additional expenses, they seemingly reduce the profit of companies without any obvious economic or legal rationale. The only plausible explanation

is that the firm feels pressured to operate according to existing social norms. This is an ambiguous moral obligation that depends on spatial and temporal conditions.

In order to better understand the CSR debate, we need to analyze the concepts underlying these definitions and the contradictions (hidden or explicit) between these concepts. This analysis is based on the results of my empirical research conducted at the Center for Business and Society and is supported by the IMPACT research project funded by the European Commission FP7 grant.<sup>5</sup> Here I can present some of my findings.

There are several dichotomies in the concept of social responsibility of corporations (or perhaps a better way to put it—of its managers). One dichotomy is that by addressing social issues at the expense of the firm and showing responsibility to society or to selected social groups, the firm does not serve its responsibility, ascribed by fiduciary duties, to those to whom their managers are immediately responsible—shareholders and owners. Claiming that social responsibility is superior to business responsibility is to create a hierarchy based on the assumption that business itself is a social construct that gains relevance only in a social context. This view not only justifies the primacy of social responsibility but makes shareholder responsibility a secondary issue. Why then, has business been willing to accept this claim? There are two explanations. One is based on business rationale: the fear of damaging one's reputation and the consequent loss of customers, the desire to build and protect the brand, the hope of gaining competitive advantage, and so on; the other is a reference to the ethical position of those leaders who are willing to accept such a responsibility.

A further complication is that while it is claimed that responsibility is owed not only to society in general (as a superior construct), but also to particular social groups (stakeholders), the hierarchy is not defined, making prioritization either impossible or arbitrary; a process based on ad hoc considerations. Without prioritization, management cannot handle responsibility to stakeholders.<sup>6</sup>

The social construct of CSR can be illustrated by companies' interaction with and response to pressure groups. A deeper look into this relationship shows that the components of CSR programs function independently and are different activities, simply summed up under the construct "CSR." For example, none of the companies we studied could identify a single aggregate figure for their CSR

budget. The amounts spent on environmental, labor, human rights and charity initiatives have been organized, budgeted, and executed independently by the various business units of the same company. CSR is an umbrella term and has multiple meaning for multiple actors (stakeholders). Market externalities and/or social priorities that are supposed to drive CSR include different issues that only accidentally coincide.

In many instances, companies have introduced several programs under the label of CSR that, in fact, *are not* CSR. Such activities include, according to most interpretations of CSR, philanthropy, charity, sponsorship, and volunteer programs. These activities do not address the externalities and the harm companies cause through corporate action; they do not alter production lines or change products/services in order to eliminate harmful or adverse impacts as CSR programs (by definition) should. In these cases it is unclear what kind of responsibility obligates the company to launch a philanthropy or sponsorship program. What would justify such a responsibility if any existed? How would it correlate with CSR? Companies are receiving numerous and competing requests for supporting such programs and they support only a few. Very rarely is a choice made by evaluating the society's overall needs. The consequence is that instead of implementing a CSR strategy, companies engage in standalone philanthropic, charity, or sponsorship programs.

If, however, CSR is a demand by the non-business actors (including the state) on the business players, it is just a matter of time to codify this demand so that it can be enforced. In that case CSR would be a similar and calculable cost as any other cost or tax that legal compliance requires. In my opinion, the change in the interpretation of CSR and its definition provided by the EC is a clear sign of a shift in this direction. It coincides with the demands of several NGOs to make, as a first step, CSR reporting mandatory and, as a second step, CSR itself mandatory. Such a change in the European Commission's policy toward CSR may have serious consequences in the state-firm relationship and may promote more state intervention in business. This trend is already obvious in countries with transition economies.

### Impact of State Intervention

Why are governments involved in CSR at all? Why would the state support CSR with policy tools? The underlying assumption is that CSR has social benefit and, consequently, it reduces the costs of social programs the state has to finance. In other words, CSR is a vehicle for wealth redistribution. This assumption, however, needs empirical underpinning. In any case, the state

considers CSR programs as social investments. Companies focus on environmental, human rights, and labor issues in their CSR programs and they claim to



Why are governments involved in CSR at all?

behave responsibly when they address these issues at their own expenses when legal regulation is missing or incomplete. The state supports these efforts for the social benefits it provides and for sparing national and local authorities the costs of addressing those externalities.

So does it mean that the corporation is responsible to the state for delivering CSR programs? Would it not be simpler to levy extra tax on corporations? There are several attempts in the literature to resolve this dichotomy. According to one framework, developed in the early 2000s,<sup>7</sup> four types of public sector roles can be differentiated in encouraging CSR and developing public policy: *endorsing*, *facilitating*, *partnering*, and *mandating*. The *endorsing role* involves providing political support; the *facilitating role* involves subsidy schemes and tax incentives; the *partnering role* involves collaboration of government organizations with firms as participant or facilitator in different initiatives; and the *mandating role* involves the definition of minimum standards for responsible business performance embedded within the legal framework.<sup>8</sup>

We found little empirical evidence that governments of transition economies apply any of these tools. The facilitating and partnering function is almost completely missing and even endorsement is largely consequential: the initiatives in the field of environmental, labor, or human rights may also be interpreted as CSR activities. Similarly, the mandating role is also aimed at specific areas rather than at CSR in general and, again, only external observers grant the CSR.<sup>9</sup>

Our research indicates an important shift in the mandating role in transition economies, particularly since the beginning of the financial crisis of the late 2000s. The mandating approach of the state in developed EU countries aims at establishing a policy/legal framework for CSR in order to help wealth redistribution legitimized by consensual business participation encouraged by government. This is a clear example for harmonizing corporate goals with social priorities. Transition economies, instead of applying so-called soft regulations (manifest mostly in the minimum requirements for standards of business behavior), tend to introduce “hard regulations” that mandate companies to comply with legal regulations in areas that previously have been considered fields of internal business decision making. The case of the Cold Winter Days Program is a clear proof of this tendency. The state most frequently imposes regulations to share social burdens in more profitable business sectors. Social priorities are the pretext and justifications for state intervention and for the establishment of instituting a legal framework to help force wealth redistribution without the consent of companies. Pushing the arguments to an extreme, the position of post-communist governments is that CSR should be interpreted as a new tax regime. So an important difference between mandating CSR and latest post-communist government approach to CSR is that the latter does not even put its mandates into a CSR context but simply requires social contributions from companies through different additional tax regimes that reference social responsibility.

## Implications for the Future

A potential explanation of this behavior is related to government failures or imperfections. In the economic literature state or government failure is used in the limited sense that the state is unable to provide development opportunities, more precisely when the state is unable to provide adequate levels of social services.<sup>10</sup> This is comparable to a market failure, which is defined in economics as a phenomenon when the free market is unable to efficiently allocate goods and services and, consequently, additional actions are needed by intervention into free market activities (or beyond the market) to deal with the inefficiency.<sup>11</sup> State imperfections are issues relating to the quality of governance defined in political science literature under three categories: democracy, the rule of law, and efficiency or effectiveness. Our discussion in this chapter relates most closely to problems with the third category (efficiency/effectiveness). Indeed, we can see that the problem extends beyond economies in transition.<sup>12</sup>

Even if we assumed that CSR was needed to overcome state failures, should not CSR remain an optional tool, even if it is the most optimal? This question raises many important issues for further research: How does the meaning of responsibility change? To whom should the firm be responsible and through what kind of mechanisms? Will there be a new role for the firm in social wealth redistribution? Would this role ultimately replace the present function of CSR?

## NOTES

<sup>1</sup> Peter Hardi and Katalin Romics, *E.ON Hungary: CSR—Social Obligation or Financial Burden?* Center for Business and Society Working Papers, CEU Business School, Budapest 2011.

<sup>2</sup> Energy-supplying companies, including the Hungarian branches of foreign corporations, are required to pay an 8 percent Robin Hood tax beyond corporate taxes.

<sup>3</sup> *GREEN PAPER Promoting a European framework for Corporate Social Responsibility*. European Commission, Brussels, COM(2001) 366, § 2/20-21, 6-7.

<sup>4</sup> Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, “A renewed EU strategy 2011-14 for Corporate Social Responsibility” (Brussels, COM (2011) 681, § 3/1,6. Available at [eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0681:FIN:EN:PDF](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0681:FIN:EN:PDF) (accessed 21 Dec. 2012).

<sup>5</sup> Hardi and Romics, *E.ON Hungary*.

<sup>6</sup> Stakeholder mapping, a well-known technique to offer prioritization in the company’s stakeholder relationship, is only a pragmatic solution to the problem.

<sup>7</sup> Tom Fox, Halina Ward, and Bruce Howard, *Public Sector Roles In Strengthening Corporate Social Responsibility: A Baseline Study* (The World Bank, 2002).

<sup>8</sup> Hardi and Romics, *E.ON Hungary*, 7 (emphasis added).

<sup>9</sup> Hardi and Romics, *E.ON Hungary*, 40.

<sup>10</sup> See also Glenn Rayp and Nicolas Van De Sijpe, “Measuring and Explaining Government Efficiency in Developing Countries.” *Journal of Development Studies*, vol. 43, no. 2 (2007).

<sup>11</sup> Francis M. Bator, “The Anatomy of Market Failure.” *Quarterly Journal of Economics*, vol. 72, no. 3 (1958).

<sup>12</sup> Bo Rothstein and Jan Teorell, “Defining and Measuring Quality of Government,” in *Good Government: The Relevance of Political Science*, edited by Soren Holmberg and Bo Rothstein (Edward Elgar Press, 2012).





Noémi Alexa

Chapter 1.8.

# IS THERE A WAY OUT? PROMOTING INTEGRITY IN CEE THROUGH A SOCIAL ENTERPRISE

## CHAPTER IN BRIEF:

- ❏ The chapter is a personal recollection of founding and managing an influential anti-corruption NGO in CEE.
- ❏ Strategic coherence and quality of delivery are key to an organization's sustainability, even if external factors do not always allow for success.
- ❏ The lack of interest and commitment on behalf of the political and business elites to curb corruption results in window-dressing anti-corruption measures.

**T**his chapter offers a case study based on my personal experience of being the executive director of Transparency International (TI) Hungary. Between 2007 and 2013 I led the social enterprise that stood up to the deeply entrenched culture of corruption that characterizes Hungary—but also many other countries of Central and Eastern Europe (CEE). The task was often frustrating and the outcomes were far from what I had hoped for. Yet the story of our efforts highlights challenges which, I believe, any social entrepreneur—and, surely, any corruption fighter—will face trying to operate in our “free market in its twenties.”

## Corruption Trends in CEE

Long after the transition period of the 1990s and joining the European Union, corruption risks in most CEE countries continue to constitute significant threats to conducting business. The Corruption Perceptions Index released by Transparency International (TI) every year measures the perceived level of corruption based on different worldwide indicators of economic and institutional development. Compared to Western European countries that have average corruption perception scores of sixty-four, CEE countries largely underperform with average scores ranging between forty and sixty.<sup>1</sup>

The country reports put together in 2011 indicate similar problem areas in CEE. Legislation to ensure integrity and the resources to implement are in place in most countries, but the enforcement is weak and also culturally conditioned as it was presented by Yusaf H. Akbar and Vukan Vujic in Chapter 1.6. Most country studies also reveal that integrity is not rooted in the society and in institutions. This results in lack of integrity mechanisms in the government and in the private sector and the still prevailing relations of patronage and clientelism. The strongest institutions across the region are state audit agencies and offices of ombudspersons, while the private sector and political parties financed by them are the weakest pillars of the national integrity system. Almost all countries lack proper regulation on campaign finance, lobbying, and the protection of whistleblowers.

The correlation between economic development, competitiveness, and corruption has been long studied by scholars like Douglas Beets, Pranab Bardham, and Susan Rose-Ackerman.<sup>2</sup> In case of the region in question the difference in competitiveness between the CEE region and the “old” EU is even more striking than in the level of corruption. According to the Global Competitiveness Report the performance of EU average is 35 percent higher than the competitiveness of CEE.<sup>3</sup> The *2013 World Competitiveness Scoreboard* published by the World Competitiveness Center indicates that the competitiveness of the EU countries without the CEE region is 27 percent higher than that from CEE<sup>4</sup> (see Chapters 1.2 and 2.1 for thorough discussions of the CEE competitiveness).

Due to the nature of corruption in the region and the interconnectedness of state and business sector, it is hard to expect systemic change from legislators and enforcers. The limitations of the state engagement in promoting socially responsible corporate behavior have been thoroughly discussed by Peter Hardi in the previous chapter. Accordingly, the idea that a social enterprise can help to overcome this twin government and market failure appears in principle attractive. TI successfully implemented this model in a number of international settings. My goal was to replicate it in Hungary.

## Social Enterprise to Curb Corruption

Transparency International was founded in 1993 as an advocacy organization to ensure uniform anti-bribery legislation all around the world. Rules in





the United States criminalized the bribery of foreign public officials, but laws in Germany allowed companies to deduct the amount of bribes from their taxes. This practice created market distortions and incentivized the use of lower-quality products and services for higher prices in poorest countries. TI not only convinced the OECD to establish the international Convention on Combating Foreign Bribery that would stop this practice but also would bring together enough German companies to exercise pressure on their government to adhere to the Convention in 1997.<sup>5</sup>

After the adoption of the Convention, TI has grown to be the leading international nongovernmental organization to fight corruption. Today, TI is present in 100 countries around the world through its national chapters and has a Secretariat in Berlin. The Hungarian Chapter of TI was established in 2006 with the aim to become an independent center of corruption-related information and advocacy in the country.<sup>6</sup> Maintaining the principles of TI we raised funds from donations and grants to operate and we sought to cooperate with all relevant stakeholders: politicians, government officials, the media, and the business sector.

Early on, we built our strategy by seeking answers to the following questions:

- ❏ What to do against corruption?
- ❏ How to get funds to support our fledgling organization?
- ❏ What kind of organization do we want to establish?

We started off by answering the last question first and we opted for a professional, highly visible elite organization that interacts mostly with high-level decision makers and the media. The quality of the professional content was cru-

cial in order to ensure the credibility of the organization. As there was no comprehensive, scientifically founded data about the roots and causes of corruption in Hungary we decided to carry out a thorough situation analysis. The Berlin Secretariat provided the methodology and, as we did not have the expertise for judging the performance of all institutions, we recruited experts from different fields. Raising funds to cover the cost of the study forced us to do heavy networking in academia, the private sector, and the diplomatic community.

The strategy proved to be successful from several points of view. One year after the foundation of the organization TI Hungary had working contacts with all relevant experts on corruption in the country. It published an overall situation analysis about the roots and causes of corruption, which generated high media coverage. Based on the findings of the study we understood how corruption worked in Hungary, raised more funds, and were able to ensure continuous presence in the media. The results of the study also helped to define the strategic priorities of the organization, which included reforms in: (a) campaign finance, (b) public procurements, and (c) the protection of whistleblowers.

### Campaign Finance

Party and campaign finance is the root of corruption in Hungary—and in many other countries in the region.<sup>7</sup> Parties need money to win elections and the money comes from the business sector, largely through illegal donations. Firms that make financial or in-kind contributions to parties are rewarded with state contracts or favorable regulations once the supported party gets into power.<sup>8</sup> Governing institutions are thus embedded in a concrete set of social ties.<sup>9</sup> In Hungary, this elite consists of politicians, foreign investors, and their “comprador intellectual allies.”<sup>10</sup> The system serves the interests of those who belong to the elite and have the money or power to exert influence.

Transactions between politicians and businesses are hidden through the chain of intermediary companies such as law firms and advertising agencies. Rules do not force any player to publish real spending and, as a result, the reports about campaign spending are normally false or incomplete. According to estimates, parties tend to spend four to ten times more than the threshold set by the Hungarian law.<sup>11</sup> To change campaign finance regulations a two-thirds majority is needed in the Parliament. Before 2010 it meant that votes from big power blocks: the right-wing Fidesz and the left-wing MSZP were necessary for any amendment. All parties except for Fidesz officially supported changing the law. But it is hard to tell whether the then-governing parties would have been so enthusiastic had Fidesz changed its mind.

TI Hungary together with Freedom House Europe started to call for negotiations with party leaders and leaders of foreign chambers of commerce in early 2008. Besides providing the professional content to a new law, TI Hungary's task in the process was to put Fidesz under pressure to support the amendment.

The project was backed up with frequent media presence, dedicated group of ambassadors of major investing countries, and loosely formulated cooperation with chambers of commerce. It was clear from the beginning that without pressure from private sector on the involved parties, negotiations would lead to a deadlock, as it precisely happened after the chambers of commerce abandoned the project. From there on negotiations failed and political commitment to change the system remained mainly on rhetorical level.

The above example confirms the theory of Anna Grzymala-Busse that ruling elites do not just decide on how to extract money from the system, but they also set up the institutional structure of a country in a way that it supports extraction of funds.<sup>12</sup> The example of failing negotiations on both the private and political sides indicates that the structure established by the elite is burdensome, but still lucrative enough not to be changed.

### Public Procurement

Traditionally, Hungarian public procurement laws were extremely convoluted. The relevant legislation consisted of more than 400 paragraphs and twenty-three by-laws that were amended several times yearly. The uncertain legislative environment—often reflecting the formalist bureaucratic thinking discussed by Maciej Kisilowski in Chapter 3.3—was coupled with a weak Procurement Arbitration Board that was not independent from the government.<sup>13</sup> Irregularities have been detected in 65–70 percent of procurement processes either because of lack of expertise or because of corruption.<sup>14</sup> The most problematic phases of a procurement process were the definition of selection criteria and the period of implementation, when contract amendments and changes of conditions were frequent. In this chaotic environment, TI Hungary found it appropriate to introduce Integrity Pacts—a tool developed by TI and tested with good results in several countries.<sup>15</sup>

The aim of Integrity Pacts is to make public procurement free of corruption by using an external monitor, who proactively takes part in every step of the procedure, ensures publication of all relevant material, and reports on incidents. The



Institutions are set up in a way that supports corruption

monitor works with a government from the moment the idea of a tender comes up until the fulfillment of the contracts. This way, the monitor can ensure that red flags of procurement—such as useless investments, too strict criteria in a

tender call, modifications of terms during contracting, underperformance and changing contract terms during fulfillment of a contract—are filtered. In legal terms, Integrity Pact is a contract between the monitor and the authority. Once the decision is taken about the tender, it becomes a tripartite agreement between the authority, the winner, and the monitor.<sup>16</sup> The most famous cases where

Integrity Pacts were successfully implemented are Milano Metro, Schönefeld Airport in Berlin, and a number of projects in Mexico.

TI Hungary had worked on the introduction of Integrity Pacts in Hungary since 2007. Our first order of business was to make the tool compliant with Hungarian procurement laws. After consultation with a wide range of procurement experts from business and government, and with the help of the Transparency Working Group of the Hungarian Business Leaders Forum, TI Hungary found the legal solution to make Integrity Pacts compliant with the ever changing Hungarian procurement law. Once the legal issue was solved, TI Hungary faced the resistance of central and local authorities to use Integrity Pacts due to fear of transparency on behalf of decision makers. Finally, the National Bank agreed to launch two small pilot Integrity Pacts. After their success, the Swiss Contribution Office decided to help overcome this general skepticism and to cooperate with TI Hungary to pave the way for a big pilot project. The leader of the Swiss Contribution Office pushed the idea through the Hungarian institutional system and the media. Since the pilot project, one additional pact was signed for the reconstruction of a nursery school in 2012.

### **Protection of Whistleblowers**

In 2007, the notion of a whistleblower was hardly known in Hungary and in other parts of the region. The general public did not regard the lack of protection of whistleblowers as a problem. Our strategy to address this problem was to convince the Minister of Justice about the need for introducing the whistleblower protections. We pointed to political and financial benefits for the government. The U.S. embassy organized workshops and roundtable discussions for the Justice Ministry staff with U.S. experts. TI Hungary provided the minister with a detailed policy memo on the topic. At the end, we managed to win the minister's support.

Ministry public officials drafting the legislation did an excellent job. But the proposal they came up with aimed at setting up a new anti-corruption institution to investigate corruption cases and protect the whistleblowers. International experience tells us that in an environment marked by high political influence, new institutions either will become window dressing or will face personnel changes and budget cuts as soon as they begin to go after top-level politicians or businesspersons.<sup>17</sup> Still, the draft law was a step forward.

The proposed reform was to be introduced in two acts: One on the protection of whistleblowers and another on the institutional framework. Both were passed by the Parliament in 2009. Yet the institutional framework was successfully vetoed by the president. What emerged was an awkward situation of having protections of whistleblowers without an office where those whistleblowers could report wrongdoing. Only in 2013 did the government finally pass the institutional part of the reform. TI Hungary considers this recent law woefully insufficient.<sup>18</sup>

## Challenges and Adaptation

As our attempts to pursue the above-mentioned strategic priorities produced mixed results, we faced a number of strategic and operational challenges. For instance, to raise funds for our operations, we established the Corporate Supporters Forum. Yet, as it turned out, very few enlightened business leaders were willing to financially support our work since integrity is an issue not strongly embedded in the Hungarian business culture. Compliance was a barely known concept until just a few years ago. Multinationals had their codes of ethics and compliance programs but business integrity was not a high priority on the CEOs' agenda.

An even greater challenge came in 2010, when the country's political landscape changed completely. The right-of-the-center Fidesz won a landslide majority in the Parliament. The new administration started to use its electoral mandate to nominate political appointees to lead previously independent oversight institutions. Lawmaking process was accelerated at the expense of stakeholder consultation.<sup>19</sup> Our strategy of dealing with high-level decision-makers ceased to be successful. Businesses, politicians, and the government formed an ever more closed circle. In a sense, what happened was the opposite of what Peter Hardi discussed in his chapter— that is the state, rather than forcing corporate word to become more socially responsible, became the force pushing for haphazard legislative changes with potentially harmful consequences. The result was the decreased staff morale and Board's dissatisfaction.

After months of heated internal debates, our team decided to use public pressure as a tool to advance our objectives. The new approach for public attention required building up a social base with completely different and more expensive communication channels.

Abandoning the policy of not dealing with concrete cases, TI Hungary opened a legal advice center for victims and witnesses of corruption. With the help of investigative bodies the center gave advice to those who wanted to report corruption cases. We increased our engagement in awareness raising campaigns. TI Hungary started activities in major summer festivals with creative activities aimed at young people such as water fights and dance flash mobs. In the course of our research we turned our focus to the young generation and issued a report on youth integrity as well as one about corruption risks in higher education institutions. We launched a competition for high-school students and drafted a handbook on corruption for high school teachers.

## Lessons Learned

Although, based on the exact academic definition of “social entrepreneurship” introduced by Bala Mulloth in Chapter 2.6, TI Hungary may not really be a “social enterprise,” I believe that my tenure as the organization's CEO taught me a number of real-life les-



Content attracted funding and not the other way around.

sons—about anti-corruption and social entrepreneurship alike. To ensure funding and organizational background there are some principles that I found important to follow when building up TI Hungary.

Content attracted funding and not the other way around. Many NGOs in Europe try to survive by constantly adapting to whatever the latest call for proposals ask for, whether they come from Brussels or national governments. TI was obviously not immune to the constraints of major funding programs. But from early on, we made a strategic decision to treat the focus and coherence in our work as an important value. Indeed, there were several occasions when we outright declined money offered to us for projects that were not in our strategic focus.

To set up a social enterprise required an extremely large number of supporters from very different sectors and backgrounds. Without their contribution the social enterprise would not have existed, therefore it was crucial to care about all stakeholders. For me as the CEO, it meant that my personal time management was an important success factor for the entire organization. Key supporters often expect quick and flexible access to the leader of an NGO they assist. That required me to plan and divide my time carefully between inward-oriented functions (e.g., managing my team) and the outward-oriented ones (such as fundraising). Proper prioritization of tasks as well as excellent help of personal assistant allowed me to achieve the goal of keeping in touch with all important stakeholders.

Most decisions that TI Hungary took were based on the consensus of the Board. The time for discussion and opportunity for expressing opinions made it possible to ensure long-term cooperation among Board members and the staff. In general, the Board composition is an extremely important early consideration for a social enterprise. Although it is tempting to invite to the Board everyone who can promise substantial support, TI Hungary opted for a small but active Board that provided essential background support to the executive director.

Ultimately, the credibility of TI Hungary was mostly due to the fact that the mission was crystal clear and delivery was of high quality. High substantive quality of our work was judged positively, brought money to the table, and increased the confidence of stakeholders. When our “brand” became associated with high quality, that reputation also acted as a powerful motivator for our team to continue to excel. People work at social enterprises because they are passionate about the cause. If early on you make your team realize how well they can deliver, they will feel both empowered and obligated to perform later on. The motivation of the staff and members of the network is a value that a leader has to build on.

It is difficult to judge the performance of an anti-corruption NGO in terms of its mission. The experience of TI Hungary confirms that, in our region, it is unlikely for a government to seriously commit itself to curbing corruption. As governments are linked to business elite, the effective involvement of the private sector in fighting political corruption is also rare. Therefore, a social



enterprise needs to engage citizens to exercise pressure on decision makers. The results of this strategy still have not been measured, but donors appreciated the strategic shift.

All in all, through my experience at TI Hungary I have learnt that, despite the civil sector's weaknesses in CEE, NGOs can operate on a high level. That is the lesson in nonprofit management. In terms of anti-corruption lessons, however, it



Increased engagement of citizens might force change in CEE.

appears that improving legislative background, the international framework set by the EU, and the economic development cannot by themselves ensure the desirable level of progress on anti-corruption policies in CEE. That is why,

anti-corruption activist should more seriously tap on the engagement of citizens – perhaps the only source of power which can truly change the way our “free market in its twenties” operates.

## NOTES

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<sup>5</sup> Fritz Heimann, Sophia Coles, Gillian Dell, Ádám Földes, *Exporting Corruption: Progress Report 2013 Enforcement of the OECD Convention on Combating Foreign Bribery* (Transparency International, 2013). Since then forty countries that generate 90 percent of outward foreign direct investment around the world joined the Convention although there are questions about the effectiveness of its enforcement. See OECD, *Working Group on Bribery* (Paris, 2013).

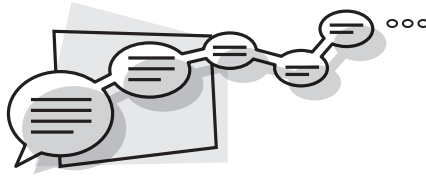
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<sup>8</sup> Dorottya Sallai, “European Union Lobbying and the Golden Cage of Post-Socialist Network Capitalism in Hungary,” *Journal of Common Market Studies*, vol. 51, no. 5 (2013), 948–964.

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## Chapter 1.9.

# CEE'S COMPLEX SAGA: AUTHORS' DISCUSSION OF PART I

### CHAPTER IN BRIEF:

- ❏ Part I highlights the problem with CEE's innovativeness from multiple angles.
- ❏ Understanding overarching trends in CEE can help entrepreneurs manage opportunities better.
- ❏ Culture plays an important role in explaining the challenges of CEE; but it may also be susceptible to change.

**M**aciej Kisilowski: Welcome everybody to our first “Free Market in Its Twenties” discussion. We are discussing chapters from Part I, which—as Stuart wrote in his preview (Chapter 1.1)—are not painting a very happy picture of Central and Eastern Europe (CEE).

**Mel Horwitch:** I agree. Take György's chapter on innovation (Chapter 1.2). I found it to be a poignant piece. The region is in real trouble, it is not a leading innovator, and how do you break out of that? There is no easy answer to it, and we see it at our School. The chapter hints that the region may be falling further behind even as it improves, given the faster rate of growth in some other parts of the world.

The real question is: Is there a real way out of this, or will we always be laggards? Either a second tier or a third tier, as the chapter mentions. Can we ever break out? Can education play a role? Can other things play a role? There are some hints, there is R&D, there is software, but in fact the outsourcing is not moving very fast, it's moving elsewhere, the value added isn't moving here. It also men-

tions that there is variety in the region; certain countries are followers and others are moderate innovators. But nobody is leading edge, which is a real problem.

### **Innovation and Governments**

**Peter Hardi:** What is fascinating to me here is the issue of measurement. Do we have the right measures to make a judgment on innovation or the impact of R&D in CEE? György often mentions the amount of money European governments spend on innovation. But is money spent really a good indicator? In Europe we have this tendency of looking at it as a problem that you can pour money over and it will be solved.

**Maciej Kisilowski:** Exactly! Take, for instance, the European academia. Rigid, hierarchical, old-fashioned. Is giving money to many of our state universities really going to make Europe innovative?

**György Bögel:** The issue of measuring the value of a firm has remained unsolved for at least a century now. We use some indicators, such as market capitalization, but there are debates. Likewise, there are debates about whether a country needs an innovation strategy, and if so, what is the role of the state in developing and implementing it. Many experts think that when the state selects companies to support, the outcome is always a disaster. That is why I finished my chapter by mentioning the new innovation policy of Hungary as an example. But I am not sure that it is the right solution to this problem. It is a classical state-market dichotomy. Some experts are for a strong state that develops industries and some others say that the market will solve everything. Others are for a mixture of the two, but a different mixture for everyone.

**Peter Hardi:** This relationship between private and public sectors, command and control versus voluntary method, market instruments versus legal instruments, underlies other chapters as well.

**Maciej Kisilowski:** Well, your own piece, Peter (Chapter 1.7), is perhaps the best example. Though you are very careful not to be judgmental. You just describe this increasing interest of the EU in CSR and pose questions about whether it is a good thing. But if we juxtapose your chapter with Noémi's (Chapter 1.8), the issue becomes even more nuanced. Noémi's piece is a great real-life case of managing a nonprofit organization—but it also highlights the limitation of what a nonprofit can do if the state is not committed to a given policy or, more broadly, set of policy principles.

**Mel Horwitch:** In fact, you can see the same state-market problem also in Anna's chapter (Chapter 1.3). You indicate, Anna, that because of the financial crisis, traditional sources of financing have dried out. And perhaps there is some governmental response to this in the form of JERMIE funds, but there is no coalescence. And can some new private sources fill up the slack? In places where there is more of an innovative culture, these methods really serve the purpose. But in CEE? Your description is very qualitative and I think there are relatively small amounts of money involved.

## Innovation and Investment

**Anna Turner:** My impression from the data is that the only serious growth factor here is the venture capital. And that is, indeed, because these are funded by governments and the EU. This money is given to private companies whose interest is to boost venture capital investment. The rest is just not that serious. There isn't any culture in the region for these new types of investments. It's very new and we don't really know what's going to happen.

**Caterina Sganga:** Reading together the chapters by György and Anna, I wonder what is the cause and what is the effect here. Is the lack of funding the cause of the lack of innovation or is the fact that there is no stimulation towards innovation the reason why you don't see development of new forms of funding? This may be the chicken egg question, but you don't find a solution until you spot the main cause.

**Michael LaBelle:** The problem is that we are not sure what the core compe-



We are not sure what CEE's core competency is.

tency of the region is. Typically if you look at regions that do have some core competencies, these regions have networks of firms clustered together. And, generally, politicians try to protect those firms over time; they build on that, to

make it their strategic direction. The engineering skills and the education are obviously built on that.

And perhaps that is falling apart. What is unique about CEE in terms of what can be built upon, what can be more innovative, and how can we excel where other regions of the world can't? We don't have to compete everywhere but we must be equal to other regions in at least some areas. Toward that end, György identifies different economic activities, enterprises' basic functions, managing customer relations, these call centers, these types of areas that the region could develop, or has developed and where we are at least "moderate innovators."

**Stuart Durrant:** Let's face it, business angels aren't actually angels, they have expectations of financial return in the future. This is true also of venture capitalists and even crowd funding. In this context, it is thereby important to ask: What is the actual landscape with regard to the expectation of return? It is easy to say that angels are nasty people because they are only interested in a 25 percent Return on Equity (ROE). The government, of course, can keep a fixed and much lower level of interest on the funds which are dispersed. But for private investors . . . I don't mean specific data, but I would like to know what is a reasonable expectation on return in the region.

**Anna Turner:** A venture capitalist told me that he has to interview 300 companies to get nine clients. The issue goes back to our general point: there is not enough good companies to invest into. My impression is that everyone in the emerging CEE private equity industry complains about managers who have unrealistic vision of their future, overstating their future revenues and coming

up with unrealistic plans. They don't have the right business models. It seems to me that they lack entrepreneurs who have sound business foundations on which financing can be based.

**Paul Lacourbe:** Now, to everything you have said, let's add the message of the case study by Charles (Chapter 1.5). In CEE, even large companies seem utterly unimaginative. The resulting picture is not pretty indeed.

### Travails of CEE Entrepreneurs

**Paul Marer:** It is certainly useful that we discuss all these shortcomings. But we need to look for opportunities! What are the conditions, the environments, under which entrepreneurship is alive and can grow? Do we have those environments? If not, what should be done to create them?

**Maciej Kisilowski:** Well, you have Caterina's contribution (Chapter 1.4), which clearly tries to help entrepreneurs manage opportunities better, at least in the intellectual property area.

**Caterina Sganga:** Yes, that was partially my goal. But even in my chapter, the macro problems of the region that we are discussing are evident. In particular, my main argument is that it is better for innovators and entrepreneurs to protect their IP rights *ex ante* and not only worry about them at the time when enforcement actions are taken. Enforcement is actually dangerous for innovators, because they don't have money to enforce their rights. Thus prevention is the only logical choice. So why so few CEE entrepreneurs do it? In my chapter, I try to understand what may be the reason. And my best response is that so far CEE businesses have pursued mostly secondary innovation, not primary innovation. CEE entrepreneurs have thereby not felt compelled to put a patent as a hat, as an umbrella over their innovation. There was simply no need. And, in effect, there is no culture of appreciation of IP rights. This is the problem.

**Bala Mulloth:** Well, I also think there are limits to how much you can protect yourself *ex ante*. Most venture capitals would not, for instance, sign a non-disclosure agreement (NDA). So you cannot really protect your IP if you want to go to a venture capital. The only way to protect it is through a patent application. This, in turn, creates a distinction between entrepreneurs who are IT-based and those who are more research-based. For example, if you are building a molecule in a chemical lab, you can apply for a patent. But if you are building a Kickstarter on the Internet, then you really cannot protect that IP.

**Caterina Sganga:** You are absolutely right. I now have a case of a small startup that is working on a software. They have exactly this problem. Nothing is patentable but there is a lot of business potential. They need to raise money by looking for an angel investor. But the potential investors want to see what I am offering. Yet if I show them what I am offering then they will know it. And then the attorney can suggest to sign an NDA, which is the typical attorney thinking. Even if the potential angel signs it, you are unlikely to go after him if he

breaches the NDA. Because you won't have the money to do it; because he is stronger than you are.

This is again a matter of strategy rather than a matter of law. And the idea of the chapter is that, before you go to a lawyer, you should understand the problem. Because the lawyer knows much less about the problems that your company is facing. You should understand that you are the one to tell your attorney what you want to have before your attorney tells you. And, while I fully acknowledge Bala's point about limitations to how you can protect yourself as a small entrepreneur, I do believe that, in many cases, there are IP instruments shaped in a way that you can defend yourself against future attacks. It's like disease prevention: it is always better to prevent than to cure. But that requires a deep cultural shift in the minds of CEE entrepreneurs.

### Culture and Corruption

**Zoltan Buzady:** It is very interesting to me that you've mentioned a cultural perspective, Caterina. I think, in general, we Central Europeans often think



We Central Europeans often think short term.

short term. I know this from my experience when I advise startups about choosing brand names. No one ever thinks of registering it. When I did that in my first venture, everyone thought that it was foolish. At that time I came

from the UK—the culture that really values long-term thinking. But in CEE, perhaps our history has taught us that our environment is so uncertain, so volatile, that it sometimes makes little sense to plan.

**Mel Horwitch:** In this section of the book, we have the entire chapter that deals with this cultural dimension (Chapter 1.6). I mean, in the 1990s, many economists would predict that with the introduction of freedom and free markets, problems of the past would quickly disappear, and there would be efficiency of markets, and corruption would disappear under the wave of efficiency and competitive advantage. It did not happen according to the data brought up by Yusaf and Vukan. This chapter's strength is that it explicitly tries to bring the cultural background of each country into consideration, in an explanatory model. And, like Caterina, Yusaf and Vukan argue that you can train people to be sensitive to these things, and maybe you need more executive education. In the case of both IP and anti-corruption, I can only support this argument, since—as the dean of our Business School—I would love to make money out of these ideas! If nothing else, both ideas are great for executive programs, to get companies to pay for.

**Yusaf Akbar:** I may need to disappoint you, Mel, but I think that the cultural attitudes identified in our chapter are formed well before a manager arrives at the door of our Business School. I think the changes should occur at a much

earlier part of personal development, say, primary and secondary education. It's then when values that are associated with hierarchy and power distance are established.

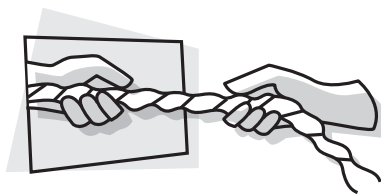
**Maciej Kisilowski:** That may be true, Yusaf, but seeing your data, I cannot help but wonder whether the hierarchy is only about the *societal* structure, or is it also about the way *organizations* are structured as well. Perhaps our ultra-hierarchical organizations, including businesses, contribute to these problems and create these corrupt inclinations and mentality. And these organizational structures can be changed through managerial training. So perhaps Mel can get some executive education money, after all!

**Paul Marer:** Focusing on the corporate culture would bring an interesting variable into the mix. Because especially with the multinationals operating side by side with local companies in CEE, you have numerous modes of responding to the same environment. Some say "when in Rome, do as the Romans do," others bring in their own culture.

**Maria Findrik:** Also, it is worth reiterating that there is still significant differentiation in terms of corruption within CEE. Indeed, I would claim that there is also a differentiation within each CEE state. Some areas of economic life, like public procurement, may be especially prone to corruption.

**Mel Horwitch:** Indeed, Yusaf and Vukan assume that the proper unit analysis is a country. But maybe the unit of analysis should be cities, which are much more cosmopolitan. Is Budapest different from the rest of Hungary; or is Warsaw different from the rest of Poland? Estonia may be a city-state itself like Singapore. Slovenia is not very big as well. I think such a focus also opens a very interesting notion of whether culture stays the same or is changing faster under the force of globalization. If you focus on cities that are most plugged into globalization—Warsaw, Budapest, Prague—do you see some changes? I think that it may be happening very quickly, but I could be wrong.

**Maciej Kisilowski:** Ok, if we begin to talk about globalization, it means it is time to finish this segment of our discussion, and let our readers move to the Part II of the book, which is precisely about the influence of the global forces...



Maria Findrik

Chapter 2.1.

PREVIEW:

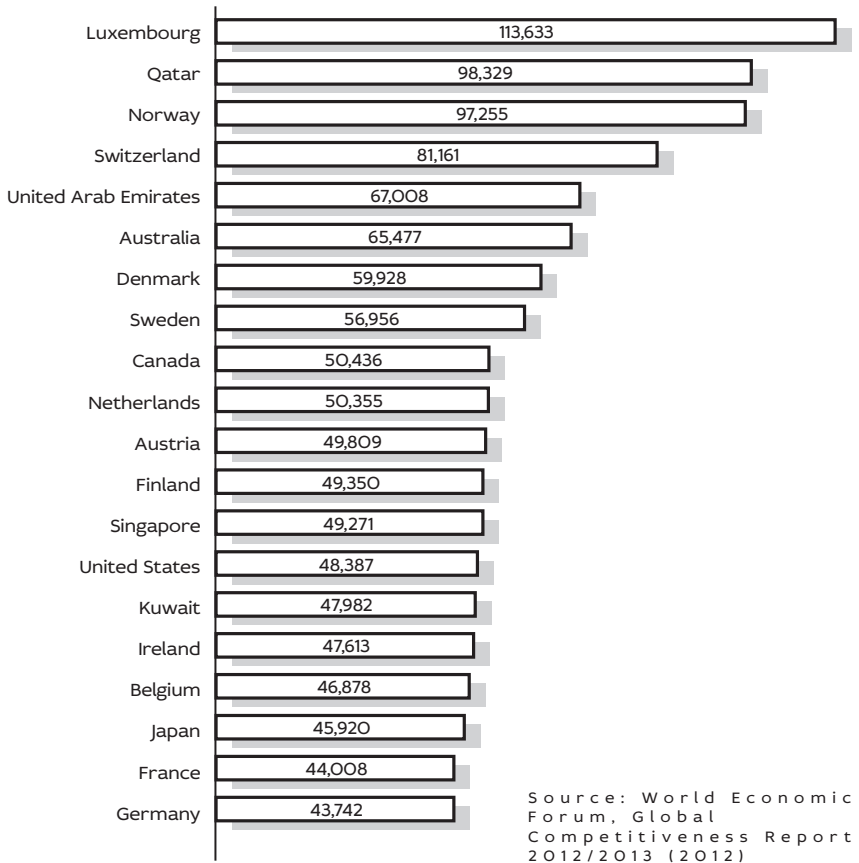
# GLOBAL FORCES AND CEE COMPETITIVENESS

## CHAPTER IN BRIEF:

- ❏ Making CEE economies more competitive in the global market is an all-important task of the region's business and political leaders.
- ❏ To improve competitiveness of their businesses, CEE managers need a thorough understanding of the most significant global trends.
- ❏ Part II offers an overview of these trends and their impact on the future of CEE's global competitiveness.

**“W**hich region/country offers the best opportunities to live and work in after earning my MBA diploma?” This is one of the most frequently asked questions by students in Central and Eastern Europe (CEE). In the past, the answer was quite simple: for many years, the United States was the most wanted career destination. Then, in the 1970s, Europe gained back its attractiveness. It became an equally preferred “port of call” that offered economic and political stability as well as highly developed welfare services. Europe’s prosperity was based on advanced technology, productivity, and democratic values. Today, to be able to respond to our students, we first have to answer the following questions: What does the world look like and what are the short- and long-term perspectives? Who is—or, more important, will be—driving the growth and shaping the world around us?

Figure 2.1.1.  
World's Leading Economies: GDP per Capita



We live in a multipolar world with three strong, competitive economic powerhouses: the United States, Europe, and emerging countries, particularly China. The next three chapters by Paul Marer, Paul Lacourbe, and John Shattuck investigate each of these focal points of the global economy. My colleagues focus on these regions' deep interconnections with each other, the rest of the world, and particularly with CEE. The principal takeaway is that while high levels of internationalization and globalization have generated unprecedented opportunities, they also created dangerous regional and global imbalances.

Against this background, the three chapters by Michael LaBelle, Bala Mulloth, and Bernadett Koles bring to our attention some new, long-term chal-



lenges and trends that transcend geographic boundaries of the above-mentioned pillars of the global economy. The danger of climate change, the rapid infusion of the entrepreneurial spirit in initiatives aimed at solving the world's thorniest problems, and the coming of age of the first generation of workers who do not remember the world before the digital revolution of the 1990s are trends that are only seemingly unrelated. Binding them together are some centrally important, underlying questions: What makes us satisfied today? What do we need and dream about to have a decent life? Is it material goods, fast-growing consumption, or ever-increasing living standards? Or perhaps advanced welfare services? Or is it more intangible values such as making a positive impact on the lives of others, the natural environment, or future generations?

Going even deeper, we should ask about the proper division of labor between governments, businesses, nongovernmental organizations, and academics when responding to the multifaceted challenges that our world faces. One clear conclusion that emerges from my colleagues' writing is that managers cannot simply assume that political decision makers will do their homework, accurately identifying the competitive advantages and weaknesses of our economies in the constantly reshaping global environment. Businesses and their leaders must actively participate in the process of ever more rapid socio-economic change; if they are not actively leading this change, they should at the very least be ready to adapt to it. Academics, especially business scholars, must also do their part. As Tibor Vörös rightly points out in Chapter 2.8, the content and methods of our teaching must also evolve if we want to succeed in preparing our students to face the dynamic complexity of today's interconnected world.

### **The Tell Tale Signs of Economic Success**

A powerful argument can be made that among the key prerequisites of our current and future well-being lie productivity and a long-term potential for its continuous growth. By considering the twenty wealthiest nations of the world (see Figure 2.1.1), one can identify three well-differentiated groups. First, we have the big oil producers (Qatar, United Arab Emirates, Kuwait, and Norway). Second, there are established Western market economies that have large markets, vast production capacities, advanced technologies, and a long history of democracy (the United States, Germany, France, Canada, Australia, and the UK). The third group consists of relatively small countries, originally rather poor in natural resources or working and financial capital, but balanced by solid socio-economic foundations, high levels of productivity, a special focus on human capital, advanced welfare systems, and well-established, transparent, and stable institutions (Luxemburg, Switzerland, Denmark, the Netherlands, Austria, Sweden, and Finland). Many of the members of this last group have jumped ahead on the list and made significant progress in the past twenty-to-thirty years. As such, they could provide some useful lessons and perspectives for the less advanced, newly emerging economies, including countries in CEE.

Figure 2.1.2.

Global Competitiveness of the World's Leading Economies & Emerging Markets

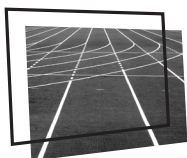
| Top 20 GCI Rank   | GCI Rank of Selected Emerging Markets |
|-------------------|---------------------------------------|
| 1. Switzerland    | 29. China                             |
| 2. Singapore      | 34. Estonia                           |
| 3. Finland        | 39. Czech Republic                    |
| 4. Sweden         | 41. Poland                            |
| 5. Netherlands    | 45. Lithuania                         |
| 6. Germany        | 55. Latvia                            |
| 7. USA            | 56. Slovenia                          |
| 8. United Kingdom | 59. India                             |
| 9. Hong Kong      | 60. Hungary                           |
| 10. Japan         | 62. Bulgaria                          |
| 11. Qatar         | 66. Russia                            |
| 12. Denmark       | 71. Slovakia                          |
| 13. Taiwan        | 72. Montenegro                        |
| 14. Canada        | 73. Ukraine                           |
| 15. Norway        | 78. Romania                           |
| 16. Austria       | 80. Macedonia                         |
| 17. Belgium       | 81. Croatia                           |
| 18. Saudi Arabia  | 87. Moldova                           |
| 19. Korea         | 88. Bosnia Herzegovina                |
| 20. Australia     | 95. Albania                           |

Source: World Economic Forum, Global Competitiveness Report 2012/2013 (2012)

If we focus on the productivity potential and on the capability to progress, we can identify several economic, social, cultural, environmental, political, and legal factors that significantly affect economic performance. One metric that aptly integrates these factors in a sophisticated way is the Global Competitiveness Index (GCI) published by the World Economic Forum. Figure 2.1.2 presents the ranking of the world's top economies and selected emerging markets as determined by the GCI.<sup>1</sup> The largest group of the most competitive countries—Sweden, Finland, Denmark, Norway, Belgium, Luxemburg, Switzerland, and Austria—is distinguished by high degrees of economic integration with the

world economy. Their growth is driven by exporting high-end knowledge-intensive products and sophisticated services. They are highly attractive to foreign direct investment (FDI), which provides them access to additional capital as well as to the latest technologies and know-how. In these countries, local suppliers are competitive and integrated with the global value chain. In addition, these countries have well-developed infrastructure, without which sustainable progress would not be possible. Their transportation and public utilities connect people and businesses, and help allocate resources to locations where they can be most efficiently used. In these countries, information and communication-technology penetration is very high; distance and time are no longer real obstacles.

The other important point differentiating the majority of the highly competitive economies is their commitment to the development of human capital. Their



Competitive economies are committed to the development of human capital.

expenditures on education, health care, and R&D are the highest in the world, creating a kind of social, cultural, and business environment that rewards hard, professional, and creative work as well as transparency, efficiency, social respon-

sibility, and cohesion with both citizens and decision makers that respect the rule of law. These factors definitely help overcome the lack of traditional factors of growth, such as market size or availability of natural resources.

### Growing Importance of Emerging Economies

One cannot see the complete picture of today's global competitiveness landscape without paying significant attention to the progress and influence of emerging economies. One of the most telling pieces of information here is the rate of growth. In the past decade or so advanced market economies have been circulating in the treadmill of growth and equilibrium. The GDPs of emerging countries, by contrast, are steadily growing, frequently by more than 5 percent annually, sometimes reaching double-digit rates. To be sure, the Great Recession did hit the emerging world too, with the average growth rate falling down to 3.5 percent in 2009 (the figure for advanced economies and the world as a whole were 0.6 percent and 2.7 percent, respectively). But in 2012 the emerging markets were back, with the growth rate reaching 6.2 percent (compared to 2.6 percent of the advanced economies).<sup>2</sup>

In short, over at least the past decade, the emerging countries have been the drivers of global growth, and as a consequence their share of the world's total output increased steadily. Today, 47 percent of the world's GDP is produced by the less advanced countries, compared to 25 percent a decade ago. Certain analysts say that by 2040 China and India together will provide about 40 percent of the global economic output and an even higher percentage of the world's exports. As a consequence of this consistently high growth rate in the emerging countries, hundreds of millions of people have come out of poverty over the past

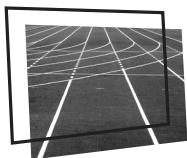
two decades. The global middle class is growing, and many of its new members are starting their own businesses, creating a solid foundation for a more stable and safer socio-political environment.

Previously closed or partially closed economies and societies are becoming increasingly integrated with the outside world. The rate of growth of exports is in the double digits and the emerging world has become a highly attractive and important destination for FDI. Although there was a very serious drop of FDI during the financial crisis globally, the emerging countries were able to improve their share of the world total.<sup>3</sup> So far, the export growth of the emerging markets has been driven by lower costs, cheap labor, the production of relatively low-quality mass-produced products, and the steady demand for high-end consumer goods from advanced economies.

But is the unprecedented growth of some emerging countries sustainable? Do they have reserves to grow fast and leapfrog further ahead? What if, in the near future, the factors that make them strong (large market size, cheap labor, huge demand for mass production, cheap export) cannot be sustained? Do they have additional competitive advantages to help them reach the higher efficiency and innovation-driven level of established economies? Could they move from the periphery to the core?

### CEE and Global Focal Points

If we define CEE as twenty post-socialist states located between Russia on the east and the pre-2004 European Union on the west, we get the region that comprises approximately 5 percent of the world's territory, 14 percent of the global population, and 11 percent of the world's economic output.<sup>4</sup> As such, CEE cannot compete in terms of market size with Asia or Latin America. But



CEE business leaders must be concerned about important global trends.

with its unique potential, stemming from the geographic location between east and west, CEE deserves to have business leaders deeply versed in and concerned about the most important global trends. These trends, analyzed by

my colleagues in Part II of this volume, will delineate the contours of CEE's global competitiveness in the years and decades to come.

When it comes to this global awareness, the first order of business for a professional, responsible manager working in CEE would be to ascertain the relation of our region with the three focal points of the global economy mentioned at the outset of this summary chapter. Chapters 2.2–2.4 provide an excellent way to start. Consider Paul Marer's analysis of the multiple crises surrounding the common European currency (Chapter 2.2). His paper offers a startlingly honest assessment of the structural problems of the eurozone: the false initial assumptions of the Maastricht Treaty, the lack of common fiscal policy and of institutions that effectively enforce member states' adherence to the eurozone's

fiscal rules, and the serious competitiveness problem of southern eurozone countries. Marer's predictions are stern: the euro crisis is here to stay for the foreseeable future. This reality must be internalized by CEE managers. Even though many CEE countries are not members of the eurozone, and others are not even members of the EU, the euro crisis does affect them in multiple ways. For numerous reasons, problems of the eurozone put an upward pressure on the risk premiums applied to many CEE economies. Less capital is flowing into the region which, combined with sluggish exports to the stagnant or contracting eurozone economies, results in slower economic growth in CEE. But the crises next door can also be viewed as an opportunity for CEE economies to improve overall competitiveness and put our fiscal house(s) in order. After all, while 2012 was the year of economic contraction in the eurozone, CEE still managed to grow by 2.4 percent.

If we take the crossroads location of the CEE region into consideration, the serious nature of the crisis analyzed by Marer may trigger a natural reaction of turning toward the east. In Chapter 2.3, Paul Lacourbe illuminates this reaction on two levels. In the most basic way, he outlines the ambitious project of the New Silk Road. According to Lacourbe, the 11,179-kilometer-long international railway connecting Chongqing, China with Duisburg, Germany (through Kazakhstan, Belarus, and Poland) opens a unique possibility for CEE. Our region, in particular, can become an important segment of the economically and geopolitically vital alternative route for Chinese products to reach Western Europe (and beyond).

But there is a more fundamental level at which investigating the Chinese example (and specifically the New Silk Road project) may be useful for CEE businesses; that is, the tremendous importance of advanced infrastructure in any competitiveness-enhancing national strategy. China's achievements in this area are stunning. Think about the high-speed train between Beijing and Shanghai traveling at 350 km/h. Although we have a long way to go, the CEE region, especially the EU11 countries, are further ahead in infrastructure development relative to other emerging countries.<sup>5</sup> The latest GCI ranking in terms of overall infrastructure places the Czech Republic as the twenty-eighth most developed; Slovenia occupies the thirtieth position, Estonia is the thirty-second, Croatia is the thirty-eighth, and Hungary is the fiftieth. Russia (101) and Romania (131) are ranked far below China (69) and India (87)—countries that understand how important good transportation is to being an integral part of the world economy. It is regrettable that EU member states decided to reduce funds in the new EU budget for 2014–2020 for upgrading and building the world's most advanced railway system.

While Lacourbe indicates that CEE business and political leaders should watch the Far East when rethinking the importance of physical infrastructure, John Shattuck argues that we should (continue to) go "Far West" in search of both investment capital and more intangible values that make today's economies

and societies more successful (Chapter 2.4). The latter is particularly significant. In Shattuck's view, the United States remains the key partner of Europe in general, and of CEE in particular, in the process of infusing more flexibility and entrepreneurial spirit into our nations and markets. In the wake of the upsets and tensions created by the Great Recession, Europeans must steadfastly confront the resurgence of nationalism and xenophobia. These old demons of the continent pose a serious threat to our democracies and seriously harm our ability to create globally competitive, knowledge-based economies. Creativity and innovation cut across all races, genders, and sexual orientations. If our businesses and societies are—or even appear to be—filled with biases and prejudices, we will be unlikely to win the global competition for talent.

### **CEE and Borderless Global Forces**

Obviously, not all global trends are directly linked to the earlier mentioned focal points of today's world economy. In Chapters 2.5–2.7, my colleagues have identified a number of forces that, in many ways, can be seen as affecting both economic superpowers and small nations alike. One of the critical areas here is the energy consumption and its effect on climate change. In Chapter 2.5, Michael LaBelle clearly shows the nature of the increasingly fierce global competition for scarce energy resources and the environmental crisis that this competition triggers. He argues that CEE could not win in such a competition bearing the economic and geopolitical costs of its outdated and inefficient energy mix. While LaBelle's long-term solution is about creating the so-called post-carbon economy, the author emphasizes the need for intermediate steps and strategies. Using the example of Poland and its investment in shale gas, LaBelle demonstrates the importance of governmental leadership in developing and implementing such capital-intensive strategies.

The next chapter by Bala Mulloth illustrates the choice we frequently face when it comes to dealing with some pressing social problems. Poland and its shale gas strategy represents a top-down approach, in which the challenge in question is identified at the very top levels of the political decision-making hierarchy, and the investment is made through the combination of governmental grants and contributions from companies with a significant levels of state ownership. While the effectiveness of this approach for Poland and its shale gas production remains an open question, one should acknowledge some general advantages of the top-down strategy, especially when a project requires significant capital infusion or when purely private investment is difficult to obtain.

With that being said, the bottom-up approach advocated by Mulloth is particularly appealing for CEE. Under this scenario, key socio-economic challenges are identified not by the government, but by a host of independent, socially minded entrepreneurs. The developmental strategy based on social entrepreneurship treats creation of economic and social value in symbiosis, thereby empowering SMEs and civil society groups to seek local solutions. From the com-

petitiveness standpoint, the bottom-up, socially entrepreneurial approach can simultaneously serve two important purposes. On the one hand, entrepreneurially minded civic leaders can contribute to solving pertinent social challenges in a more effective and cost-efficient way than under the government-led top-down approach. On the other hand, sociologists make a strong point acknowledging the correlation between decentralized social engagement of people in their communities and the buildup of human capital.<sup>6</sup> As mentioned earlier, the high level of development of human capital constitutes an all-important prerequisite for building an innovative, knowledge-based economy.

In Chapter 2.7, Bernadett Koles analyzes the linkages between human capital and sustainable economic competitiveness from a very original perspective. Koles focuses on the relationship between the early and constant digital immersion of today's youth and their potential usefulness in the labor force. The author argues that information technology can actually help the young generation acquire and develop new skills and competences required by the continuously changing labor market. Their views on work are different; they do not execute in a traditional sense but rather create. They develop new products not only as employees but also as consumers, through an interactive value creation process of prosumption.

The question of whether CEE businesses are ready for this new generation of digitally immersed workers remains. My colleague's point is that there is a lot to



No gap in IT usage exists between Western and CEE Internet kids.

do to understand the nature of the new human capital that these workers bring, and to create environments that can utilize this capital in the most effective way. The good news is that, while CEE overall is lagging behind Western coun-

tries in terms of digitalization, the gap disappears when we focus on the younger generations. No gap in the information-technology penetration and usage exists between Western and CEE Internet kids.

### Homework for All of Us

The transformational nature of the global forces discussed in this part of the book should be equally appreciated by the growing number of CEE business schools and management departments. The global digitally connected world with an increasing appetite for entrepreneurship and innovation requires a very different approach to management education. In Chapter 2.8, Tibor Vörös emphasizes the importance of new, tacit knowledge, which cannot be taught in a traditional, formal way in a classroom. Vörös shares his valuable experience using business games and simulations in teaching at CEU Business School. His teaching combines observation, reflection, idea generation, and conceptualization of new findings to help prepare future managers to solve real problems.

The business simulations Vörös conducts at the School are just one of a number of ways our academic community tries to respond to the ever more complex

world our MBA students face after graduation. We do hope that managers reading this book will share our optimism about our ability to creatively leverage the complexity that surrounds us, setting new and ambitious goals for making our businesses and our nations more competitive in the global economy.

## NOTES

- <sup>1</sup> World Economic Forum, Global Competitiveness Report 2012/2013, available at [www3.weforum.org/docs/WEF\\_GlobalCompetitivenessReport\\_2012-13.pdf](http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2012-13.pdf) (accessed 3 Sept. 2013), 14–15.
- <sup>2</sup> [www.imf.org/imf.org/external/datamapper/index.php](http://www.imf.org/imf.org/external/datamapper/index.php) (accessed 3 Sept. 2013).
- <sup>3</sup> [www.imf.org/external/datamapper/index.php](http://www.imf.org/external/datamapper/index.php) (accessed 3 Sept. 2013).
- <sup>4</sup> Data compiled based on the World Statistics Pocketbook 2011. The United Nations, New York.
- <sup>5</sup> Estonia: 32, Croatia: 38, Hungary: 50. See Global Competitiveness Report 2012/2013, 412.
- <sup>6</sup> For a classic treatment, see Robert Putnam, *Making Democracy Work* (Princeton University Press, 1992).





Paul Marer

Chapter 2.2.

# THE EUROZONE CRISES AND CEE

## CHAPTER IN BRIEF:

- ❏ Mistaken assumptions were made by the eurozone's architects, banks, and governments.
- ❏ Mistakes led to crises in four areas: growth, sovereign debt, banking, and competitiveness.
- ❏ The implications of the eurozone's possible collapse on CEE are discussed.

**T**he Maastricht Treaty, which established a single European currency, the euro, was signed by twelve members of the European Community in February 1992. The historic date was just a little over two years after the fall of the Berlin Wall, less than six weeks after the collapse of the Soviet Union, and in the midst of bloody clashes in the Balkans as Yugoslavia was falling apart. In the early 1990s the agreement to establish a monetary union with a single currency was a momentous historic event in Western Europe. At the same time, the collapse of communism that gave birth to the 'transforming economies' was the most important historic event of the period in Central and Eastern Europe (CEE).

Let's reflect for a moment. Can you think of a significant causal relationship connecting these dramatic historic events in the two parts of Europe?

Most of us probably would not be able to do so. But linked they were. The reunification of Germany was the decisive factor pushing the heretofore utopian dream of a big integrational leap forward; a West European monetary union that would become embodied in the Treaty of Maastricht. Well before

Maastricht there were detailed proposals to create a monetary union in Western Europe.<sup>1</sup> However, prior to German reunification, none of the proposals had come close to being adopted, for economic and political reasons.

The difference in 1992 was the historically well-founded fear, primarily France's, that—after reunification—Germany would become even more powerful, and thus more dangerous. France thought that the way to control Germany was to deepen European integration, so that important economic and political decisions would be made multilaterally, thereby dissipating Germany's rapidly growing relative power to drive economic, political, and potentially even military decisions in Europe. It was not difficult for France to convince other European nations that European integration was of mutual self-interest.

Another little known fact is that France had veto power over German reunification. This gave French president François Mitterand powerful leverage over German chancellor Helmut Kohl, whom he was able to privately persuade to replace the Deutsche mark with the euro. Kohl agreed only on the condition that the mighty Bundesbank would be the model of the new central bank of Europe.

### **Eurozone Faces Four Crises, Simultaneously**

A series of mistaken assumptions by the euro's architects—by commercial banks, and more recently by governments—have led to the four crises the eurozone is facing today: a competitiveness crisis, a sovereign debt crisis, a banking crisis, and a growth crisis. The first of those assumptions was that it is acceptable to establish a monetary union without banking, fiscal, and political union first. This was a brave assumption. A common currency with a uniform monetary policy will work in the long run only if each member would voluntarily pursue economic and social policies that would broadly maintain its competitiveness vis-à-vis the rest of the Economic and Monetary Union (EMU) as a group. This is primarily because neither of the two key instruments that can be used to regain lost competitiveness (the ability to implement relatively tight monetary policies and to lower the exchange rate) is available to individual countries in the EMU. And large, apparently permanent, losses of competitiveness by some members would mean that the surplus creditor countries would accumulate claims on the deficit countries that they may not be able to collect.

The EMU without a fiscal union (which in turn would require a political union) means that while the group has a common central bank, it lacks a common treasury that could issue bonds, for which all member states would be collectively responsible. The absence of such bonds means that any eurozone government that gets into debt-servicing difficulties has to rely on the willingness of other governments in the group for aid, as the Maastricht Treaty explicitly forbade the soon-to-be European Central Bank (ECB) from directly financing any public entity. However, the willingness of other governments to play this

role, and the terms on which assistance might be given in such a situation have remained uncertain.

Some of the Maastricht architects who endorsed this false basic assumption argued that a combination of the newly adopted and binding fiscal rules and the rapid economic convergence of the more and the less developed member countries (convergence that was to be promoted by the creation of the EMU), would prevent the emergence of competitiveness and sovereign debt-servicing problems. They reasoned that the ECB's monetary policy was responsible for the group as a whole, and each country's prudent fiscal policies (that would be guaranteed by the Treaty rules), would keep inflation and public debt levels in check. Supported by the free mobility of capital and labor, severe competitiveness and debt-servicing problems would not arise. However, both of these problems have arisen for reasons explained in the following section.

The binding fiscal rules that were supposed to help assure the success of the EMU refer to two of the Maastricht criteria for admission (maximum public debt not to exceed 60 percent of GDP and annual fiscal deficits not to exceed 3 percent of GDP) and to the identical provisions of the subsequent Stability and Growth Pact (SGP) intended for those already in the EMU. We know now that the binding fiscal rules have not been observed; even at admission, Italy and Belgium entered the EMU with levels of public debt nearly twice the maximum permitted. The reason for their lenient treatment: it was just not politically possible to deny EMU membership to two of the founding members of the European Economic Community. And when the German government, in 2003 and 2004, found that observing the deficit limit of the SGP would require politically painful austerity, Chancellor Gerhard Schroeder championed the ultimately successful fight to change the SGP's deficit rules.<sup>2</sup>

Overall, during the EMU's first decade of existence, there were more than 100 annual instances of non-compliance with SGP's fiscal rules. Even though it was only in Greece where imprudent fiscal policies have been the main cause of its



In the 2000s, there were over 100 annual cases of non-compliance with SGP fiscal rules!

current economic crisis, the many instances of rules being broken, apparently without consequences, eroded the binding power of the agreement. For instance, Hungary ran sustained budget deficits of up to 10 percent of its GDP

during the boom years of 2000 to 2006, becoming the only CEE EU member state country exceeding the permissible public debt to GDP ratios, even though it was supposed to move in the opposite direction to comply with the fiscal requirements of Maastricht.

Before discussing other important mistaken assumptions, let us note that there was another group of architects in Maastricht who defended the establishment of the EMU without a fiscal union, albeit with a different logic. Realizing that monetary union alone might not be able to solve any potential major prob-

lems, they assumed that when it became clear that banking or fiscal (and thus political) union would be essential to sustain the EMU, the necessary steps for further integration would be taken. This assumption, as it has turned out, can be likened to putting the cart (common currency) before the horse (fiscal, banking, and political union), hoping that the horse would materialize. So far, it has not.

### **False Assumptions about the Private Sector**

Another false assumption was that EMU rules should only focus on prudent policies for the public sector and that no attention needs to be paid to the consequences of irresponsible behavior by the private sector. This assumption was based on the idea that the private sector would always correct its own excesses. It took the financial crisis of 2008 to prove this assumption wrong. In fact, in several countries, it was the uncontrolled behavior of the private sector, including that of many banks and other financial institutions that became a major cause of the crises now gripping the eurozone. Financial institutions, most notably in Ireland and Spain, were not only willing but eager to finance construction and mortgages that led to real estate booms, right up until the bubble burst following the 2008 collapse of Lehman Brothers and the subsequent global credit freeze.

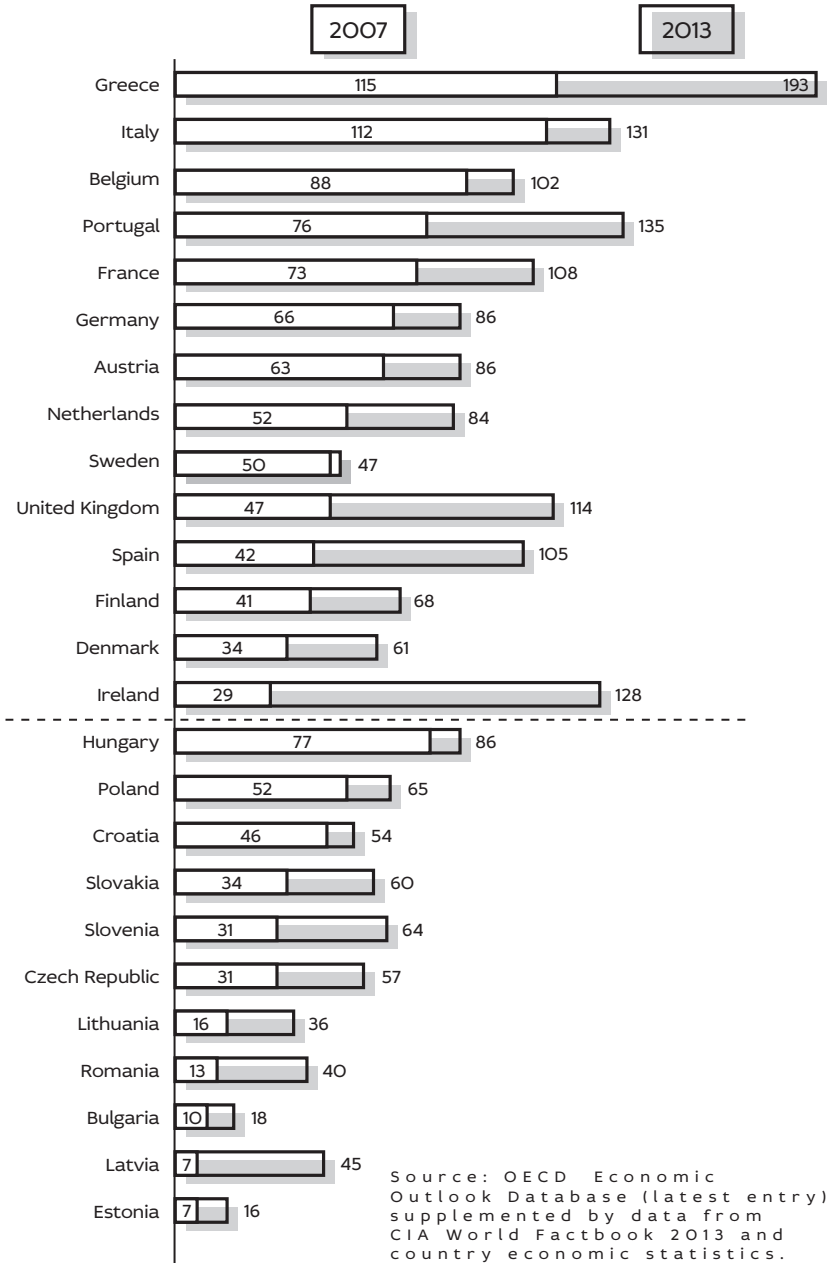
A dramatic illustration of the mistaken assumption that rules should constrain only the public sector has been demonstrated through the situation of Ireland's public debt (see Figure 2.2.1). Between 2000 and 2007, the country was a paragon of fiscal virtue; it ran an average annual fiscal surplus of 1.5 percent of GDP. In the meantime, the authorities closed their eyes to the grossly irresponsible foreign borrowing and domestic lending of several large Irish banks and even guaranteed their liabilities in full. When the bubble burst, the Irish government became stuck with some €70 billion of private debt. This is the reason—not profligate fiscal policy—why Ireland's public debt to GDP ratio jumped from 29 percent in 2007 to 128 percent by 2013. It is only with the substantial help of the IMF and of a special fund (hastily established by Eurozone governments) that Ireland managed to avoid bankruptcy.

One cause of the eurozone's public debt and the linked banking crises was the lax banking supervision practiced in several countries. If a banking union, entailing common bank deposit insurance, would have been established when the EMU was created to ensure that the supervision of banking would have been in competent central hands (the ECB, for example), then the grossly irresponsible lending decisions by the banks in several countries would not have been allowed. One reason for lax bank supervision in the Eurozone was the concern of national authorities in each country that revealing the problems of their domestic banking sectors might trigger a panicky withdrawal of large foreign funds.

In 2008, the global financial markets suffered a near-catastrophic meltdown that was prevented solely by radical and coordinated action of governments and central banks. This involved substituting sovereign credit (in the form of central bank guarantees, government bailouts of insolvent financial institutions,

Figure 2.2.1.

Public Debt Levels of 25 EU Countries in 2007 and 2013  
(As Percent of GDP)



and large budget deficits) for the credit of those private financial institutions whose finances were revealed to be shaky. Together with the impact of the Great Recession worldwide on tax revenues and stabilization expenditures, this led to very large increases in public debt to GDP ratios in many countries.

### Divergent Competitiveness

The dynamics that generated competitiveness crises for countries similar to those facing public debt crises today were the following. The EMU tried to integrate a fiscally responsible, high-saving, low-inflation, high-productivity-growth northern group of countries with a fiscally less responsible, lower-saving, higher-inflation southern group of countries (with France straddling between them). Therefore, the single policy interest rate established by the ECB in the early 2000s represented a relatively high real rate of interest in the north and a relatively low real rate in the south. This helped to trigger an economic boom in the south, fueled by large northern investments (private capital inflows), which attracted further capital that contributed to the boom.

In the meantime, structural reforms, wage moderation, and subdued consumption became commonplace in the North, which, during the ensuing decade, translated into unchanging unit labor costs, booming exports, and improved competitiveness vis-à-vis the south. In the south, economic growth accelerated, the euro was hailed as the magic bullet promoting economic convergence, and everybody was expected to live happily ever after. However, inflation in the south accelerated, unit labor costs rose steadily, and the growth dividends enjoyed by the governments were spent to finance unsustainable increases in public and private consumption (i.e., large current account deficits) and to continue to sweep serious structural problems (such as uncompetitive business practices, rigid labor laws, bloated government bureaucracies) under the rug. This resulted in a gradual and cumulatively substantial loss of competitiveness vis-à-vis the north.

### Prescription for Solving the Crises

As the strongest economic and political power and largest creditor in Continental Europe, Germany drives the direction of the eurozone. So far, the other countries have been following its lead and have been taking, albeit reluctantly,



Germany's medicine—  
austerity and  
more austerity—  
is unrealistic.

the medicine Germany has been prescribing—austerity and more austerity—starting with governments reducing their budget deficits. Germany's crisis-management medicine is based on a fundamental assumption that is

proving to be increasingly unrealistic. That is, the heavily indebted and increasingly uncompetitive countries should do what Germany did when it found itself in a comparable situation after incurring the immense cost of reunification (pulling the backward eastern part of Germany to be on par with the western

part, during which Germany's public debt jumped), resulting in a weak competitive position on the establishment of the EMU. During this transition, Germany passed a constitutional amendment prescribing a balanced budget and undertook far-reaching structural reforms.

Another justification of Germany's crisis management advice is based on the view that the huge problems in the eurozone—that is the large differences in the debt burdens of countries and their divergent competitiveness, are largely the fault of the fiscally and socially less responsible countries. Therefore, it is only proper that they be required to bear much of the burden of adjustment and do what Germany had done before them. This view is being propagated partly out of conviction and partly out of domestic political necessity. Publicly ostracizing the debtor provides the domestic political cover needed to make financial concessions for the cause of saving the euro. Why Germany's advice does not, and will not, work for the rest of Europe today is explained succinctly by George Soros:

Economic conditions are very different than they were for Germany a decade ago. The global financial system is reducing its excessive leverage and exports are slowing down worldwide. Fiscal austerity in Europe is exacerbating a global trend and pushing Europe into a deflationary debt trap. That is, when too many heavily indebted governments are reducing their budget deficits at the same time, their economies shrink, so that the debt burden as a percentage of GDP actually increases.<sup>3</sup>

This is where we stand today: Europe is facing a growth crisis simultaneously with sovereign debt, banking, and competitiveness crises. The outcomes are exceedingly difficult to predict.

### **Implications for CEE**

Eleven post-communist countries of CEE are EU members. Of these eleven, six are Eurozone insiders, five are outsiders. Being an insider means either that the country has already adopted the euro, as did Slovenia (in 2007), Slovakia (2009), Estonia (2011), and Latvia (2014), or that the exchange rate of the domestic currency is firmly, believably, and sustainably tied to the euro; or before the euro, to a strong currency such as DM, as in Lithuania (since 1994) and Bulgaria (since 1997). The six insiders that have adopted the euro or have pegged their currencies to it enjoy a fixed exchange rate with other eurozone members. Whether this is an advantage or a disadvantage depends mainly on the trends in a country's relative competitive position compared with the rest of the eurozone, as the bulk of their trade is with those that use, or are tied to, the euro.

For all six CEE insiders, being on a euro standard was rather a disadvantage during the Great Recession because during the boom years between 2000 and 2007, all experienced declining export competitiveness vis-à-vis the EMU

group. In other words, *ceteris paribus*, their economies suffered more than if their exchange rates could have declined. The three eurozone members also had to contribute their share to the common bailout funds that the eurozone had established to help Ireland and Greece (and later others), which was a modest economic burden and a domestic political headache for their governments. However, having the euro or being tied to it also gave these countries important advantages: sovereign, business, and household loans denominated in euros were easier to continue to service than it would have been with substantially depreciating exchange rates. And for Latvia, a country that faced severe debt-servicing difficulties during 2008 and 2009, it was probably easier and quicker to obtain support from the IMF and its euro partners than it would have been without such ties.

For the five outsider CEE economies with managed floating exchange rates (Poland, Czech Republic, Hungary, Romania, and Croatia), the situation was exactly the reverse. The two countries that benefited the most from flexible exchange rates were the Czech Republic and Poland. Their prudent macroeconomic and financial policies kept foreign currency borrowing by their private sectors to a minimum, so their debt-service burdens did not skyrocket as a result of their (temporarily) sliding exchange rates.

The four raging crises in the eurozone have had several negative economic effects on all the CEE countries. The public *debt crisis* is particularly acute in the countries with high levels of sovereign (foreign currency-denominated) debt and declining creditworthiness, as is shown in Figure 2.2.1. Those countries have to pay relatively higher risk premiums on their public, as well as private, debts. This problem is the most severe in Hungary where the high risk premium on its sovereign debt also reflects the current government's unorthodox legal and economic policy steps.

As a result of the *banking crisis*, the inflows of capital to CEE through the subsidiaries of West European banks (which control two-thirds or more of the banking assets in CEE) have by and large stopped, and in some cases the net flows have even reversed. This is not helpful for the availability of bank credit to the private sector (although there are other, perhaps even more important, reasons why business investment has been languishing in most countries in the region).

The *growth crisis* has severely burdened the CEE countries in approximately the same proportion as the relative importance of their exports (total end to the eurozone) is to their GDPs. As a rule, the smaller the economy, the more open it tends to be, which means that Poland and Romania are affected somewhat less than the other CEE economies.

The eurozone's *competitiveness crisis*—namely, those of its southern members vis-à-vis the northern group—probably has the least significant impact on CEE.

### Potential Collapse of the Eurozone?

There are economically sound proposals on how the eurozone crises can be resolved in a fair and equitable manner. Most of these proposals recommend



greater banking and fiscal integration and a much more balanced burden sharing between creditors and debtors than what Germany and other creditors have so far been willing to accept. Yet there seem to be severely binding ideological and



One scenario is that the eurozone, as it exists today, will collapse.

political constraints on their implementation. Therefore, one plausible scenario that must be considered is that the Eurozone, as it exists today, might sooner or later collapse. The euro as a currency will not disappear because it

has been deeply and irreversibly embedded into the global financial architecture. In the event that the eurozone as we know it today will not survive, the impact of the collapse will depend on which countries leave it, or to put it another way, which countries will take charge of the rump that remains? In either case, the immediate impact will be global panic and turmoil, a major reversal of European integration, and uncertainty. But, as this will pass, the question becomes: What will be the new equilibrium after the turmoil?

The most plausible scenario is that one or several southern members—those facing the most severe public debt and competitiveness problems—will leave, essentially leaving the northern group in charge. In this case, after the turmoil, the euro is expected to appreciate substantially and growth in the EU countries would likely return to a more normal trajectory. This would be favorable for the export sectors of CEE economies, although it will impose extra debt-servicing costs on countries such as Hungary, with its large foreign currency debt obligations by its private and public sectors.

A less plausible scenario is that Germany and some other northern members will leave, in order to stop what they perceive to be unacceptably large and seemingly never-ending transfers to the south. In this case the euro will weaken substantially, helping the southern group to regain its competitiveness. This will be unfavorable for the region's export competitiveness but helpful for servicing foreign currency-denominated debt.

## NOTES

<sup>1</sup> These included the “Barre Plan” (1969), the “Werner Report” (1970), the “Single European Act” (1986), and the “Delors Report” (1989). The latter became the basis for the Maastricht Treaty.

<sup>2</sup> “Chancellor Schroeder’s Legacy: Germany’s Leading Role in Weakening the Euro,” *Der Spiegel Online*, July 16, 2012.

<sup>3</sup> George Soros, “The Tragedy of the EU and How to Resolve It,” *New York Review of Books*, September 27, 2012.





Paul Lacourbe

Chapter 2.3.

# THE NEW SILK ROAD: CHINA AND THE EMERGING OPPORTUNITIES FOR CEE

## CHAPTER IN BRIEF:

- ❏ The New Silk Road is a plan to develop land-based transportation between China and Europe.
- ❏ The New Silk Road responds to China's key economic, strategic, and geopolitical objectives.
- ❏ The New Silk Road will encourage development of the Chinese interior.

On 31 August 2012, the 11,179-kilometer Yuxinou (Chongqing-Xinjiang-Europe) International Railway was officially put into operation. It starts at the megacity of Chongqing in Central China and ends at Duisburg near Germany's western border. It leaves China through its north-western border with Kazakhstan and crosses Russia, Belarus, and Poland before entering Germany. Via the new railway, goods from Central China can reach the heartland of Europe in only two weeks, significantly faster than the five weeks it would take by sea. Thus, the railway is more suitable for transporting high value and short shelf-life goods. When the Railway opened, trains departed for the long journey every week; but there are plans to increase the frequency to one train daily. In addition, the operator will increase the efficiency of reloading; a necessity when changing from standard gauge tracks used in China and Western Europe to broad gauge tracks used in many of the former Soviet Union countries. This and further efficiencies will reduce travel time to about thirteen days.

Figure 2.3.1.  
The Yuxinou Railroad



Source: Ministry of Commerce, Chongqing Municipal Government.

Chongqing, the final station of the Yuxinou Railway in China, is one of the country's four direct-controlled municipalities (the other are Beijing, Shanghai, and Tianjin), and the only such municipality in inland China. It has a population of around 30 million people. Since separating from the Sichuan Province in 1997, the city-district has emerged as one of China's fastest-developing regions, vital to central government's efforts to develop inland China. The annual GDP growth has averaged around 14 percent over the last decade. The city hosts a number of economic and technological development zones to target growth in specific industries. Among many products, the city has an impressive annual laptop manufacturing capacity of 120 million units,<sup>1</sup> which currently accounts for 20 percent of the world's total laptop output. Since 2011, HP has transported 4 million notebook computers into Europe via the Yuxinou Railway. Further, the city is well-connected to the coastal regions of China, facilitating the rail transport of goods from eastern China to Europe.

### China's Key Strategic Objectives

In 1937, aided by its modern military and especially powerful navy, Japan managed to capture most of China's coastal areas in a relatively short period of time. China had lost the areas that accounted for the majority of its economic output and was cut off from the key routes through which it may have imported weapons. This desperate situation made the Chinese resistance ineffectual and cost the Chinese millions of lives. This tragic episode demonstrated two of China's key strategic weaknesses. First, that most of its economy was dangerously centralized in the coastal regions; and second, that the country was heavily dependent on foreign imports. These two challenges made the country strategically vulnerable, especially in the face of a militaristic and aggressive adversary with a powerful navy.

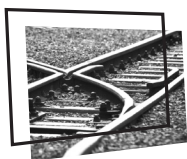
Today, China's key challenges resemble in many ways the ones of the past. It has been the coastal regions that have benefited the most during the past

three decades of rapid economic reform and growth. This is largely due to the role international trade has played in driving the development of the Chinese economy and the proximity of these regions to this economic activity. Further, China continues to rely on transportation by sea for exporting goods and importing energy and other vital supplies. And, despite some recent modernization initiatives, the Chinese navy remains quite modest compared with other major naval powers.

Economic prosperity is among the most desired goals of the Chinese people. In the last two centuries, China was a very poor country that experienced many horrible famines and nearly constant military conflict; factors that inhibited economic development. When peace finally came in 1949, the centrally planned system further impeded the development of the Chinese economy. Only during the past few decades has China been able to build a modern economy and enjoy some degree of economic prosperity. Yet even today, many elderly Chinese still vividly remember the harsh living conditions of their youth. It thus comes as no surprise that the Chinese cherish their economic prosperity, thriving after so many generations of struggle.

National security also occupies an important role in the Chinese consciousness; from defeat in the Opium War of 1840 until the end of World War II, China was regularly pillaged by various foreign occupiers. The resulting losses, measured through the number of people who perished or suffered horrible abuses and indignities, and who were kept in abject poverty, continue to influence the Chinese national psyche. Although the Chinese differ in their opinions on many issues, the need to feel safe as a country is widely shared. It is through this prism that China watches warily as the United States and its East Asian allies build up their military presence in the region. Within China, this military buildup is widely perceived as the creation of the Island Chains, with the sole objective of containing and limiting China's ambition to become a regional power.

Another important goal for Chinese people is to regain the feeling of national pride. According to the majority of 1.3 billion Chinese, China should become the center of the world. Indeed, in this respect, the Chinese do not seem to differ much from the Americans. Just consider the American tendency to distrust



90% of trade is transported by sea, over which China has little control.

international institutions and reluctance to ratify international treaties. The main differences that exist between the Chinese and the American nationalism are merely consequences of humiliations and foreign abuses that China suffered

during the past two centuries. In any case, the fact that more than 90 percent of trade volumes must be transported overseas, an operation over which China has little control, is widely perceived as an obstacle on the path of reaching the international position that Chinese people believe their country deserves. Given China's current vulnerability, China often feels obliged to occupy a low profile

position on the international stage even in disputes that involve China, despite the fact that the country is now the world's second largest economy.

China will surely continue to strengthen its military presence in the Pacific region. But with the vivid memory of the destruction of Japan during World War II, the country may not find it wise to pursue an overly confrontational policy with the United States and its regional allies. Turning inland may thereby be an acceptable alternative for China to achieve its strategic objectives. Gone are the days when unpredictable relations with the Soviet Union virtually closed China's northeastern borders. The new door to Europe has opened and the New Silk Road is the manifestation of this opportunity.

### **The New Silk Road Plan**

The New Silk Road (NSR), a terminology commonly used in Chinese media, is in fact a comprehensive strategy for opening a new, vibrant trade route between China and Western Europe, which might be favorable for the export sectors of some CEE economies (see Chapter 2.2); of which the Yuxinou Railway is only a part. The NSR strategy consists of two parts: the domestic part concerns large swaths of the western regions of China, and the international part addresses transit countries in Central Asia and Central and Eastern Europe (CEE).

The goal of the domestic portion is to build up the interior of China, which (as has already been mentioned) is far less developed than coastal areas. Key investments must be made in the development of infrastructure; especially in transportation, energy (particularly hydro-power), and telecommunications. Large amounts of money have been made available for these ambitious undertakings. In 2008, for instance, the Western Development Bureau affiliated with the Council of State chose ten major infrastructure development projects for the western regions; the total budget of these undertakings was to exceed \$64 billion.<sup>2</sup> The list featured prominently new railway lines between Guiyang to Guangzhou, Lanzhou to Chongqing, and Kashgar to Hotan. Highways between Wanyuan and Dazhou in Sichuan Province, and Shuikou and Duyun in Guizhou Province have also been opened. Airports in Chengdu, Chongqing, and Xi'an have undergone major upgrades. By the end of 2012, China had been carrying nearly 200 large construction projects in the western regions, with a total investment of approximately 3.68 trillion Chinese Yuan (\$600 billion).<sup>3</sup>

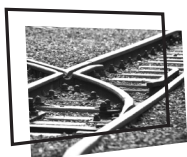
Economically, these efforts make a lot of sense. Today, the GDP per capita in Shanghai is five times higher than that of the poorest provinces. Massive migrations and talent drain from the less developed regions has subsequently followed. This seemingly insatiable demand for labor has caused double-digit annual wage growth for many years. This trend has decreased competitiveness in the developed regions, especially among the most labor-intensive manufacturing activities. These labor-intensive industries are now reversing this trend and pioneering the move inland, to regions of even cheaper labor and where the quality of infrastructure has reached adequate standards.

The key to the international portion of the NSR strategy is to develop transportation infrastructure that would facilitate the transport of large quantities of goods at a reasonable cost, while creating highly desirable trade and business opportunities for CEE (see Chapter 2.1). The Yuxinou Railway and similar railway projects are likely to be the primary mode of transportation. Yet a highway network, passing through Kazakhstan and the Orenburg region of Russia, is also envisioned. In the future, railway, highway, or a combination of the two, will be available alternatives. As the governments of China and Bulgaria currently negotiate, part of the journey may even be completed by ship, via the Black Sea.<sup>4</sup>

As with the *mode* of transportation, the exact geographic *location* of the key NSR routes may also vary. The goods going through Russia may exit through Belarus or Ukraine. From Ukraine, the goods may reach Austria through Hungary or Slovakia. The route through Belarus to Poland and Germany, two of the larger and more prosperous economies of Europe and the route of the newly operational Yuxinou Railway, may serve as a better indicator of further NSR directions.

### Areas the NSR Will Affect

Without a doubt, the NSR will significantly shrink the Euro-Asian continent. Goods with the made in China imprint will strengthen their already strong presence in Europe. Products that are made in inland China, with access to cheap labor, will have even more attractive price-quality ratios, furthering the competitive advantage of Chinese goods on the European market. Due to the



The New Silk Road will shrink the Euro-Asian continent.

long travel times, imports up until now have been restricted to mostly commodity products with long shelf lives. With the delivery time of the transportation of bulk goods falling to two weeks from three months, a new portfolio of products can now be imported from China. Rapid and frequent train transportation allows companies to transport products in much smaller batch sizes than through sea transportation, thus marginalizing existing hurdles for the east-west trade. In particular, the CEE countries, previously on the periphery of this trade and which had to wait for shipments from German and Dutch ports, are now closer to China than their Western counterparts.

To understand the NSR's full potential impact, one might examine the impact of the original Silk Road during the Mongol Empire. At that time, when porcelain and silk traveled west while spices and gold moved east, many trading towns and cities along the route were born and flourished. With the advent of the initial implementations of the NSR strategy, we will begin to see history repeat itself. As the goods travel along the NSR, trade will stimulate local economies. It is worth noting that Yuxinou trains, currently departing Europe, leave with empty carriages that are filled along their way to China. An attractive business

opportunity is waiting to be capitalized. Already, the railway is being used by BMW, Audi, and Volkswagen to transport auto parts produced in Germany to the companies' plants in China.

The NSR, however, is also different in many important aspects from the ancient Silk Road. In the modern world, the movement of physical goods is always accompanied by flows of capital, talent, and knowledge. The east-west trade of physical goods is only the beginning of a new era. Given the vast potential of this trading route, how will major nations such as Russia, Germany, and China cooperate and compete with each other? We can expect that the ever more complex interactions between China and the West will likely impact peoples' lives in ways and areas that few can expect.

## NOTES

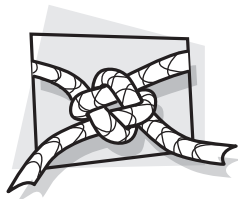
<sup>1</sup> Available at [www.chinadaily.com.cn/business/2011-04/14/content\\_12327183.htm](http://www.chinadaily.com.cn/business/2011-04/14/content_12327183.htm) (accessed 29 Jan. 2013).

<sup>2</sup> Available at [www.chinadaily.com.cn/bizchina/2008-06/22/content\\_6784587.htm](http://www.chinadaily.com.cn/bizchina/2008-06/22/content_6784587.htm) (accessed 29 Jan. 2013).

<sup>3</sup> Available at [china.org.cn/china/2012-12/19/content\\_27463481.htm](http://china.org.cn/china/2012-12/19/content_27463481.htm) (accessed 29 Jan. 2013).

<sup>4</sup> Available at [www.scmp.com/article/590652/new-silk-road-link-beijing-black-sea](http://www.scmp.com/article/590652/new-silk-road-link-beijing-black-sea) (accessed 29 Jan. 2013).





John Shattuck

Chapter 2.4.

# THE EUROPEAN CRISIS AND THE UNITED STATES

## CHAPTER IN BRIEF:

- ▣ The United States has a vital stake in helping Europe deal with its economic and political crises.
- ▣ European leaders and managers should take their own steps toward strengthening ties with the United States.
- ▣ CEE should be a special focus of the U.S., given its educated workforce and location at the crossroads between East and West.
- ▣ An earlier version of this essay appeared in *The Boston Globe* on December 9, 2012.

**T**he Middle East and Asia dominate the daily foreign policy briefings of a U.S. president, but a region of the world closer to home should be getting more of his attention. The economic and political crisis in Europe poses a direct threat to the United States. The United States and the European Union are the largest mutual stakeholders in each other's economies, global partners in international security, and, despite differences in perspective, supporters of a system of shared values. But the EU today is a struggling behemoth, and U.S. interests in Europe are increasingly at risk.

America's roots in Europe run deep. For more than three centuries waves of European immigrants have landed on the shores of the New World, pushing America steadily westward, building its highways, bridges and railroads, powering its economy and providing it with a constant supply of talent and creativity. Millions of Americans trace their family origins back to Europe, and

over the centuries many have sought refuge from persecution and oppression at the hands of European rulers. Twice in the first half of the twentieth century, U.S. troops played a decisive role in ending the world wars that had devastated Europe. In the second half of the twentieth century, U.S. and European economic, political, and military security became increasingly intertwined. Within that security environment the idea of a united Europe was conceived and developed into the European Union.

### **From Success to Crisis**

Until recently, the EU was a remarkable success story. With crucial U.S. support from the Marshall Plan, Europe was rebuilt from the ashes after World War II, developing a common market that grew into an economic union based on free enterprise, democracy, and open society. The EU was able to expand to the East in the 1990s, thanks to the fall of the Berlin Wall, German reunification, a strong common currency, and robust economic growth.

U.S. policy encouraged extension of the EU economic umbrella to Central and Eastern Europe (CEE), following an earlier U.S.-supported expansion of NATO, as a means of consolidating new democracies, stimulating market economies and opening opportunities for trade and investment. The potential contribution of the CEE countries to the EU and the global economy can be found in the region's high levels of education, technical skills, and historic scientific preeminence, as well as its former industrial base and relatively low-cost labor market. As a result, U.S. and Western European investment poured into Central Europe in the first decade of the twenty-first century.

The financial crisis of 2009 and the economic contraction that followed proved catastrophic, reversing two decades of integration and creating a multi-speed Europe now in danger of fracturing unless strong fiscal controls and greater democratic governance are established at the center.

The crisis extends beyond economics into the political realm as it was analyzed in Paul Marer's chapter. The European Central Bank and other EU institutions, for example, are perceived by many European governments as threats to national sovereignty. Tensions are reflected in the financial markets, widespread protests, and political gridlock in EU capitals trapped by austerity policies. With bureaucratic power concentrated in Brussels, there is a growing sense among European publics that EU institutions lack democratic legitimacy, and politics at the national and local level have begun to turn against EU decision making. As the crisis has deepened, nationalism, xenophobia, and increasingly powerful right-wing extremism have emerged across the continent.

### **America's Vital Stake**

As Europe's principal geopolitical partner, the United States has a huge stake in the EU's future. It also has substantial economic and security leverage. U.S. investors are responsible for more than half of all direct global foreign invest-

ment in the EU.<sup>1</sup> Nearly half of all the assets of U.S. foreign affiliates are invested in the EU. The United States is the EU's largest trading partner. Total U.S. investment in EU countries is three times larger than in all of Asia, while EU investment in the United States is eight times higher than in China and India combined.

The transatlantic relationship plays a major role in shaping the global economy. The EU and U.S. economies together account for nearly half the entire global GDP, and either the EU or the United States is the largest trade and investment partner for most other countries in the world.<sup>2</sup>

In addition to its economic leverage with the EU, the United States as the creator and managing partner of NATO is a huge co-investor in European security. NATO has protected security interests of both the United States and the EU over the past two decades in Bosnia, Kosovo, Iraq, and Afghanistan, and for more than forty years before that, when Europe was on the front lines of the Cold War. The intractability of the current EU crisis has made Europe more receptive than usual to U.S. engagement. But there is a widespread perception among Europeans that the United States has pivoted toward Asia, is preoccupied by its own fiscal challenges, and is no longer interested in Europe's problems.

### Agenda for Reengagement

The perception of U.S. disengagement from Europe was dispelled by President Barack Obama's announcement in February 2013 that his country intends to negotiate a major new trade agreement with the EU. Such an agreement would be the largest bilateral trade deal ever reached, and could add an estimated half of a percent to the EU's annual growth. In addition, a transatlantic trade agreement would come at a time when the global economy is struggling and other trade talks have bogged down over differences between developed and less developed economies. The agreement would be similar in structure to the North America Free Trade Agreement negotiated between the United States and Mexico in 1993, but more than three times larger in trade volume (\$4.7 trillion versus \$1.5 trillion), and much smoother in potential regulatory discrepancy and labor dislocation. U.S. and European regulatory regimes are less divergent than U.S. and Mexican regimes, and labor markets are more closely matched.

Beyond the trade agreement, a series of decisive low-cost actions could be



U.S. should encourage stronger fiscal controls and less stringent austerity policies in Europe.

taken by the United States to shore up its relationship with Europe and help strengthen the EU. The most effective way for President Obama to reassert U.S. interests in Europe is to create an effective diplomatic, economic, and policy

infrastructure of EU-oriented agencies in Washington, DC, as well as per-

sonnel in Washington, Brussels, and other European capitals. This would raise the visibility of U.S. representation in EU institutions while broadening and intensifying the consultative process began by the U.S. Treasury and Commerce Departments during the first Obama administration.

The United States could use its economic leverage to press European governments to accede to stronger EU fiscal controls, less stringent austerity policies, and stimulus measures to address slow growth rates. Equally important, the United States could reinforce its shared values with Europe by supporting the EU measures to combat racism, xenophobia, and extreme nationalism.

With respect to European security policy, it is time for the United States to reorient its security support toward the Mediterranean and other border NATO countries. This would have the dual effect of providing a spending stimulus for southern European states suffering most from the economic crisis, and shifting security resources in response to growing European vulnerabilities to the turbulence in North Africa and the Middle East.

To rebrand American policy toward Europe, the United States should explicitly state that strengthening the European Union is a central objective of U.S.



Markets need reassurance that the U.S. has not pivoted away from Europe.

economic and security strategy. European leaders have spoken often about the importance of saving the EU, but their voices have been tempered by national politics. A US strategy backed by substantial economic and security

leverage could make the transatlantic case for the European Union. To reinforce this message, the United States could expand its student and professional exchange programs with EU countries and the visa waiver program for EU citizens.

### What It Means for Managers

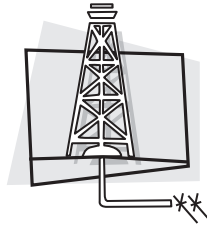
Markets need reassurance that the United States has not pivoted away from Europe. Open society leaders in Europe need reassurance that they are not alone in their struggle. And European citizens, especially minorities, need to hear that Europe will not be allowed to fall prey to destructive tribalism.

European business leaders should respond to U.S. deepening engagement with Europe by taking advantage of new opportunities presented by stronger trading ties and developing new ways of turning competitors into potential transatlantic partners. In CEE, business leaders should embrace entrepreneurship and risk-taking as the transatlantic model for economic growth, and turn away from the state-dominated corporate model of the old regimes. Finally, European leaders should think twice about pivoting to the East themselves at a time when transatlantic opportunities may offer the best pathway out of the economic crisis.

## NOTES

- <sup>1</sup> See data available at “Investing across Borders” section of the World Bank website at <http://iab.worldbank.org> (accessed 29 Jan. 2013).
- <sup>2</sup> See, e.g., Trade Profiles 2012, World Trade Organization, Geneva, 2013.





Michael LaBelle

Chapter 2.5.

# CLIMATE CHANGE AND THE POST-CARBON ECONOMY: INNOVATION THROUGH SHALE GAS

## CHAPTER IN BRIEF:

- ▣ Businesses must prepare themselves for the transition to a zero-carbon economy.
- ▣ Collaboration of governments, society, and business will foster innovation and help prepare for global disruptions.
- ▣ Polish shale gas is an example of such cooperation.

**B**usinesses have a choice: plan and operate in a business-as-usual scenario, or look ahead and develop a sustainable path for the company and environment. Innovative and strong firms choose the latter. Businesses contribute to a post-carbon economy by working with social and government partners. These partnerships help in clearing a path to a post-carbon economy. The path of business-as-usual is lined with environmental and economic crises.

The effort to transform business and society in a sustainable manner results in new commercial spaces for entrepreneurs and corporations. This is profitable

for local and international businesses—along with their R&D facilities, supply chains and local customers—located in CEE. Sustainable transformation is primarily a bottom-up process. Environmental, energy, and social issues are embedded in the local. In the past, businesses could think they were isolated from environmental and social problems. Today's sustainable firms recognize how the local environment impacts and boosts its operations. Climate change affects the local, and it also disrupts business. Business-as-usual must give way to more resilient business planning.

This chapter lays out three paths forward. Two paths describe how concerted effort over the long-term instills resiliency through strategic and sustainable partnerships, the third path has no partnership and the environment and society are excluded. The year 2050 emerges as an important milestone to cut global CO<sub>2</sub> emissions by 30–70 percent of 2000 levels, which will result in a 50 percent chance that the global temperature will not rise more than 2°C above preindustrial levels;<sup>1</sup> this may sustain our lives-as-usual approach. A technology, which is now entering CEE and may help or hinder this goal, is shale gas technology. In this chapter, the shale gas industry in Poland is analyzed for how it conforms to the regional effort to develop innovative industries and a low-carbon economy. The development of new energy technologies involves entrepreneurial companies, state institutions, and social agreement. The chapter describes the dichromatic development pathways of an innovative carbon-based industry (shale gas) against the broader need to go zero carbon. The result is a perspective that if a carbon-based business can go low to zero carbon, other sectors can too.

### **Which Path Do You Choose?**

The pathway toward a post-carbon economy, instigated by society's reaction against climate change, can unfold in roughly three different ways. Business must prepare and lay the groundwork for the transformation today. Understanding how risks are mitigated as the scenarios unfold not only protects business from unexpected costs but enables firms to seize on emerging opportunities ahead of competitors. The effects of climate change will be felt in changing consumer tastes, business regulations, technologies and services, jointly creating a new business environment.

Businesses are not impervious to the natural environment. Natural events negatively impact how a business operates; supply chains and the lives of employees can each be left in shambles from flooding or other natural disasters. Two major 2012 natural events in the United States and their costs were connected to climate change, causing stark impact on business: the costs of drought and Hurricane Sandy were \$50 billion and \$71 billion, respectively. Quarterly business cycles must adjust to the cyclones of climate change. The natural environment can cause short-term disruption while climate change-related legislation and social change can disrupt business for the long-term.



Figure 2.5.1.  
PACT Scenario Descriptions

| SCENARIO                                                                                            | DESCRIPTION                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|-----------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>Spacecraft</p>  | <p>“[T]ransition process ... planned and managed by governments and big ... stakeholders in a ... consensual ... movement worldwide, driven by the recognition of limits ... and the willingness to anticipate and manage them in due time. ... The consumption model and behavior remain roughly the same. ... Centralized technologies and innovation are driven by big industries and government.”<sup>2</sup></p>                                                             |
| <p>Smartphone</p>  | <p>“[B]ottom-up ... transition process, where municipalities, NGOs and citizen networking play a leading role in redesigning welfare and security values. ... Society moves towards a ‘beyond GDP’ perspective.” Technological innovation is focused on “small and smart technologies.”<sup>3</sup> The prevalence of ICTs and decentralized renewable energy increases. Social behaviors and consumption preferences include practices related to climate change mitigation.</p> |
| <p>Hard Way</p>   | <p>A poorly managed transition process, imposed by a recurrent and increasingly severe “crises resulting from the competition for scarce ... resources and from growing extreme climatic events. To some extent, <i>Hard Way</i> looks like a business-as-usual scenario without a ‘happy ending’.”<sup>4</sup> Society will need to turn quickly away from fossil fuels and towards renewables. Lifestyles will quickly change.</p>                                              |

Based on Bertrand Chateau and Briec Bounoux, “PACT: Pathways for Carbon Transition: 3 Scenarios to Assess Post-Carbon Transitions” (2011)

The three pathways toward a zero-carbon society (see Figure 2.5.1) outline the broad trends influencing business. Also known as PACT (Pathways for Carbon Transition) scenarios, these were developed by Bertrand Chateau and Brieuc Bougnoux within the EU-funded research project and aim to outline a post-carbon society and how to establish it by 2050. This includes looking at energy sources, transport, material technologies, and how social actors respond during this transition period.

The scenarios are important for business. For example, if heavy state involvement in the economy is projected (Spacecraft), then companies conforming or riding the wave of government-supported R&D, or aligning a firm's R&D activities to governmental priorities, can ensure their investments pay off. The Yuxinou Railway discussed by Paul Lacourbe in Chapter 2.3 is an example of this strategy in the area of infrastructural development. If the government plays an absent role (Smartphone), and a consumer driven lower carbon economy emerges, then business decisions, largely self-financed and with shorter payback periods, will become more critical to pursue.

The profitable commercialization of products or services, whether for niche or mass markets, is reliant on a broader social and business environment. Spacecraft provides the most predictable business environment; and in contrast, the impact of the "Hard Way" scenario may result in disturbances to the long-term



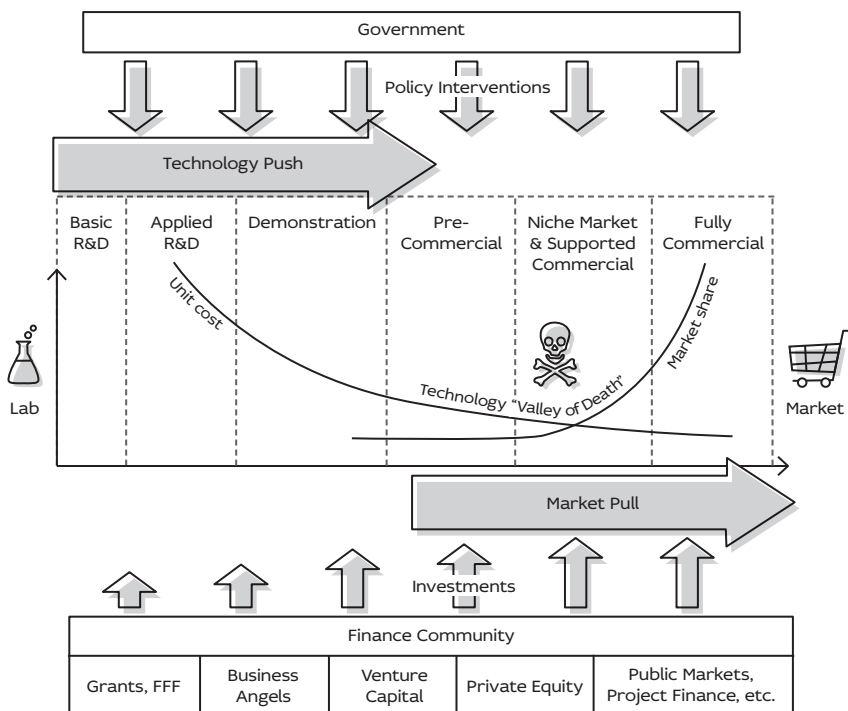
Climate change is able to disrupt emerging technologies.

innovation cycle of companies and technologies. The lifecycle of certain technologies pushed by government R&D funding and ultimately pulled by market demand, may be disrupted or proven to be inadequate, if the long-

term business environment drastically changes. Figure 2.5.2 shows the path new technologies take from R&D to full commercialization. The path involves a range of funding mechanisms and challenging trial periods, from pre-commercial to commercial stages. Once the technology is ready, if the market demand does not exist then the product or service dies in the "Valley of Death." Climate change is another variable able to disrupt emerging technologies.

In the Hard Way scenario, technological innovation and the hard switch in economic activity will require rapid alternative business strategies to adjust to depressed consumer demand. The long-term policy cycle may be interrupted, resulting in stranded products and services between the R&D stage and the full commercialization stage in the Valley of Death. For CEE's large and small innovative companies, the financial losses could be huge if products in the R&D phase and those emerging on the market are not able to fulfill their predicted lifecycle. The following case study exemplifies why getting through the Valley of Death is reliant on choosing the right pathway to a zero-carbon economy.

Figure 2.5.2.  
Push-Pull of New Technology



Source: Mary Jean Burer and Rolf Wüstenhagen, "Which Renewable Energy Policy Is a Venture Capitalist's Best Friend? Empirical Evidence from a Survey of International Cleantech Investors," *Energy Policy*, vol. 37, no. 12 (December 2009)

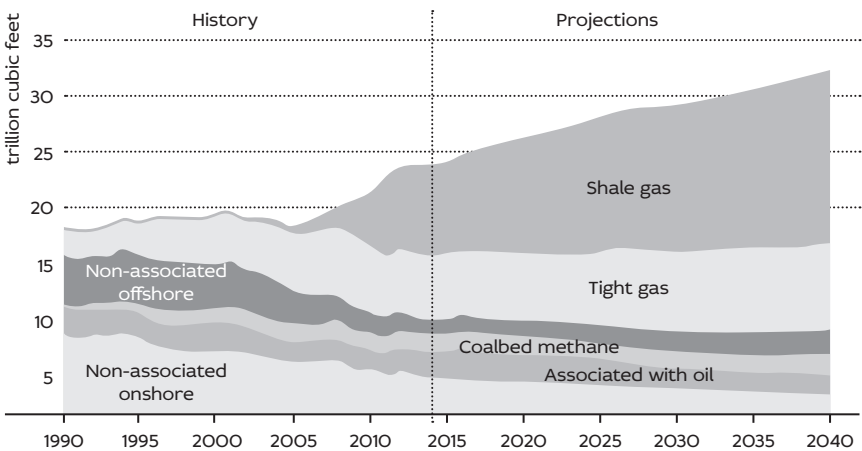
Resource Riches and Shale Gas

The drive toward a post-carbon economy focuses on the reduction of carbon emissions. Natural gas is fueling the global economy to a new energy system. In the United States, a technological revolution is upsetting the established and emerging business models. For high-carbon and energy-intensive industries, such as the coal, steel, and chemical industries, and even zero-carbon industries, such as wind and solar, a fundamental market shift is occurring. The emergence of technology to extract gas from shale rock deposits upsets businesses on both sides of the carbon-business spectrum. The dramatic uptick in the amount of gas extracted by using hydraulic fracturing technology to access gas in shale rock formations has altered the U.S. energy landscape. Figure 2.5.3 demonstrates the growth of shale gas in the U.S. gas market mix.<sup>5</sup> As a result, gas prices for U.S.

residential consumers fell 18 percent between 2008 and 2010<sup>6</sup> and lower gas and electricity costs are benefiting energy intensive industries, which are as a result moving to the United States.<sup>7</sup> Explored in this section is how the Polish government is now developing and pushing shale gas extraction technologies to make it a viable domestic and international business.

Lower cost (shale) gas emerged from affordable hydraulic fracturing technology (commonly known as fracking, a process that involves the injection of water, sand, and chemicals into the rock mass) actively under development since 1997. This was at a time when gas supplies were expected to run out, forcing the United States to import high priced gas. The outcome of a merger between two gas companies resulted in engineers putting together two separate gas extraction technologies. The result was an extraction price drop per well, from \$375,000 to \$85,000. This breakthrough also occurred in concert with government-funded research, which, in 2007, found pores on the scale of nanometers that contain gas molecules, further improving the potential of the extraction process.<sup>8</sup> The success of shale gas as a market changer demonstrates the outcome of Research & Innovation (R&I) over the long-term and the potential of cooperation between the U.S. government and private industry. The walls of the Valley of Death were scaled together by industry and government to achieve a new dynamic in the U.S. energy market.

**Figure 2.5.3.**  
US Historical and Projected Natural Gas Production



Source: U.S. Energy Information Administration, Annual Energy Outlook 2013 Early Release

CEE is looking at shale gas to create a similar revolution in national energy markets. The biggest proponent of shale gas extraction is the Polish government and industry. Shale gas is viewed by the Poles as a means to reduce reliance on Russian supplied gas and induce lower (or more competitively) priced energy. Carbon emissions from gas are less than coal. The benefits for the country emerge in the form of greater security of supply (less imported gas from Russia), lower priced domestic gas, less CO<sub>2</sub> emissions, and the creation of jobs. Poland perceives a competitive advantage in two key areas: the potential to attract energy intensive industries and to develop and deploy new extraction technologies. These areas draw on the unique geology and history of the Polish fossil fuel industry.

### **Pathways for Polish Shale Gas**

The perceived benefits of shale gas in Poland are greater than the actual physical or financial viability of extraction. At the end of 2012, only a limited number of test wells had been drilled with mediocre results. Nonetheless, the theoretical impact factor is fuelling a concerted government effort because of the potential future role in the economy and society. The future of the gas sector is rosy because it also matches closely with the start of each carbon pathway scenario—at least in the short to medium term. Due to the impact of climate change and without a long-term transition plan away from fossil fuels the economic and sectoral collapse of the fossil fuel industry is predicted.

The Polish shale gas sector is starting off on the Spacecraft scenario trajectory. Large amounts of government funds are pouring into R&D, state-owned companies are leading exploration and possible exploitation, and five state ministries each have a role in developing the sector. Boosting gas use for electricity production lowers CO<sub>2</sub> emissions by Poland, as 90 percent of electricity is produced by coal. The switch to gas also may be cheaper than paying for carbon emission allowances in the European Union's carbon emissions trading scheme. The result: energy prices and Polish industry remain competitive.

Currently, R&D activity is focused on extraction and exploitation with little consideration of how to capture and reduce carbon emissions. Previously, the Polish government was a big proponent of carbon capture and storage (CCS) due to its reliance on coal. The use of CCS allows coal or gas to contribute to a low/zero-carbon future by moving carbon emissions to underground storage sites, rather than releasing the emissions into the atmosphere. However, funding and political support has declined for CCS in the demonstration phase, leaving CCS gasping for air in the Valley of Death. Ironically, the monetary and political capital, in Poland and other places, has shifted from CCS trial projects to shale gas development. In a zero-carbon economy shale gas and CCS need to go hand-in-hand for a fully sustainable future, but currently, only the most profitable side is being developed.

## The Promise of Shale Gas

The development of shale gas in Poland aligns with the broader economic goals and entrenched interests in the country. State-owned companies profit from extracting shale gas, the state and local communities gain additional revenue and overall energy prices (may) fall. The technology, in the short- and long-term also aligns with other social and business interests. By having shale gas technology satisfy other state goals, governmental support is ensured.

In 2012, the Polish government established a €119 million R&D fund, expected to be matched by energy companies, including those owned by the state. Polish companies will be able to export their technology in line with the global development of the shale gas industry. Poland's neighbor Ukraine, with the same geologic shale rock deposits, is a natural export market. Industry, academia, and government institutions are all recipients of this targeted spending, which further builds a significant support base.

Domestically sourced shale gas may also benefit Polish industry: imported Russian gas is expensive, Polish shale gas can be priced lower. Benefits of competitive energy pricing can impact chemical and other large energy-intensive industries, potentially attracting industries and future investments away from



The slogan of Poland's shale gas business may be "clean gas—good enough."

high-priced markets, such as neighboring Germany. Poland is seeking a competitive advantage through lower electricity and gas prices. Germany may have clean energy with higher priced solar power, but Poland is only one step

lower on the clean energy ladder. They are pursuing a low-cost solution and developing a high-tech domestic shale gas business, using the slogan "clean gas—good enough."

International conflict may arise as the stress of climate change grows on societies. The historical relations between Poland and Russia were once explained to this author by a Polish interviewee in terms of brotherly love: it is always the little brother that gets beaten up by the older brother. Seventy percent of Polish gas consumption is supplied by Russia's Gazprom. This places Gazprom in a near monopolistic position, resulting in limited competition on the gas market and Polish vulnerability to supply cuts (which may also occur due to disputes between Russia and Belarus, similar to previous disputes between Russia and Ukraine). Diversification of gas supplies develops a more competitive and liquid market while boosting the level of long-term stability.

The Polish government has set up an explicit strategy to push domestically created shale gas technology and allow companies to pull it to the Polish and global market. Shale gas emerges not just as a cleaner fuel, compared to Polish coal, but as a new industry that prompts job creation, export opportunities and greater energy security. This path emerges as a viable solution for Poland to situate itself between higher priced and cleaner countries in the West and bal-

ance energy security concerns in the East. The path to a lower carbon economy emerges in the story of shale gas development in Poland.

### **Winning in the Green(ing) Game**

The broad brushstrokes contained in the PACT scenarios can only point toward a general adjustment period that businesses will experience. While the timelines discussed are for the long term, businesses and governments in CEE can begin to understand how they want to position themselves as the economic and social changes unfold. Those able to perceive limited government intervention can more actively, through social actors, push toward a more localized strategy built on local relations that emphasize green or sustainable sourcing. Mitigating business risks, through shrinking supply chains or limiting exposure to non-renewable resources and fossil fuels, can further insulate a business from volatility that emerges as climate change events impact supply lines.

Conversely, a concerted international effort by governments will require companies to strengthen international partnerships. Technology transfers funded by governments may require new business strategies or strong partnerships with state institutions, international businesses and NGOs. Creating a business that sustains itself over the long term is as important as creating a business that practices sustainable principles. With the principle of sustainability at the center, medium- and long-term considerations are taken into account; these are essential for long-term investments and business development.

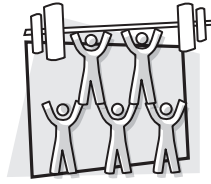
Understanding the shale gas revolution in the United States and in Poland provides a picture of an industry that benefits from, but runs counter to, carbon reduction efforts. As the use of fossil fuels continues into the long term, it is essential to learn how an industry that is contributing to climate change is able to benefit, adjust, and contribute to a low-carbon solution; a solution that may ultimately lead to a zero-carbon economy. Poland has united state institutions and companies on a lower-carbon trajectory; yet from the scenarios, it is clear that business-as-usual will undermine the industry and the country in the long term. Therefore, a greater adjustment and contribution to a lower-carbon future is necessary to sustain the economic benefits that shale gas offers. How shale gas fits into Spacecraft and Smartphone scenarios must be considered.

The alternative to a sustainable business environment is filled with uncertainty and the deceleration of economic growth. The expansion of business in CEE rests on meeting short-term market demands; however long-term R&D efforts and the innovation of new products and services, which still must traverse the Valley of Death, require long-term thinking for the market begin its pull. The emergence from the Valley requires a particular natural environment to have the years of investment and effort pay off. A dramatically altered environment will require focus more on short-term paybacks and less on larger innovative solutions. The climate, society, and even businesses, need a concerted effort to provide a stable transition to a post-carbon economy.

## NOTES

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Bala Mulloth

Chapter 2.6.

# THE RISE OF SOCIAL ENTREPRENEURSHIP

## CHAPTER IN BRIEF:

- ▣ Entrepreneurship evolves and adapts itself to accommodate new forms of value creation such as social entrepreneurship.
- ▣ The apparent conflict between social and commercial priorities is a central characteristic of social entrepreneurship.
- ▣ Social entrepreneurship presents an attractive model for CEE.

Contemporary entrepreneurship is highly diverse. It can involve traditional business/commercial activities, not-for-profit entrepreneurial activities focused on social outcomes as well as activities focused on social problems, which trigger entrepreneurial behavior. One reason why a major and growing segment of entrepreneurship deals with social issues is that entrepreneurship may be able to meet unfilled social needs of diverse population groups worldwide. In view of this development, the discussion and solution of social problems has recently entered the sphere of business.

The notion of social entrepreneurship is fairly recent, emerging in the late 1990s. It gained prominence with the awarding of the Nobel Peace Prize in 2006 to Mohammad Yunus for establishing the Grameen Bank and for promoting micro financing in Bangladesh. As one recent review put it:

The capacity of individuals and communities to self-organize into groups and associations in order to provide goods and services they need has been around for a very long time, but the emergence of more

enterprising social ventures which aim to achieve financial sustainability has only recently attracted the attention of scholars. Social entrepreneurship combines the economic benefits of entrepreneurship with the delivery of social and environmental outcomes, and has the potential to assist the economic and social development of individuals and societies around the world.<sup>1</sup>

The concept is also increasingly becoming a topic of interest in business schools around the world. More importantly, social enterprises have become increasingly abundant and proven to flourish especially in resource-constrained environments, such as inner-city neighborhoods in the United States<sup>2</sup> and small villages in Brazil and India.<sup>3</sup>

However, it is important to make some careful distinctions with other forms of entrepreneurship especially as social entrepreneurship gets more popular. That is why, in the subsequent sections of this chapter, I will define the main concepts that differentiate and make up the field of social entrepreneurship.

### Social Entrepreneurship as an Emerging Field of Study

Social entrepreneurship research draws from a number of areas of distinguished academic work. In particular, it has roots in literature related to non-

profit organizations,<sup>4</sup> corporate social responsibility,<sup>5</sup> and entrepreneurship.<sup>6</sup>

The term *social entrepreneurship* has multiple implied meanings. A good place to start may be the perspective of Bill Drayton, the founder of Ashoka. In

his view, social entrepreneurship is a concept that can help identify and solve societal problems worldwide through the championing efforts of people in local communities.

Yet, as it is illustrated in Figure 2.6.1., the scope and focus of definitions of social entrepreneurship vary significantly. Some commentators associate the concept primarily with creating positive social change. The emphasis here is on societal transformation with the business model and funding strategies considered optional. Social entrepreneurs in this case consider achieving their specific social objectives as their prime criteria and do not really care about income generation.

Another approach focuses chiefly on revenue generation in the pursuit of social outcomes. Here, social entrepreneurs assume the double bottom line of being financially sustainable as well as having social impact. In this case social entrepreneurship is very much about income generation with the objective that most of the extra income will be put back in the business. Most of the socially entrepreneurial organizations that have made an impact in the past few years have appeared to adopt this double bottom line approach. The process of



Social enterprises flourish especially in resource-constrained environments.

Figure 2.6.1.

Definitions of Social Entrepreneurship, Units of Analysis & Research Focus<sup>4</sup>

| Author(s)                       | Definition                                                                                                                                                                                                                                                                                      | Unit of Analysis                    | Research Focus |
|---------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------|----------------|
| Christian Seelos & Johanna Mair | Social entrepreneurship is the simultaneous pursuit of economic, social and environmental goals by enterprising ventures and has gradually found a place on the world's stage as a human response to social and environmental problems. <sup>5</sup>                                            | Subset of business entrepreneurship | Opportunity    |
| Paul Tracey & Nelson Phillips   | Social entrepreneurship refers to the creation of positive social change, regardless of the structures or processes through which it is achieved. <sup>6</sup>                                                                                                                                  | Innovation                          | Opportunity    |
| Sandra Waddock & James E. Post  | Private sector leaders who play critical roles in bringing about 'catalytic changes' in the public sector agenda and the perception of certain social issues. <sup>7</sup>                                                                                                                      | Private sector                      | Individual     |
| Paul Light                      | A social entrepreneur is an individual, group, network, organization, or alliance of organizations that seeks sustainable, large-scale change through pattern-breaking ideas in what and/or how governments, nonprofits, and businesses do to address significant social problems. <sup>8</sup> | Social entrepreneur                 | Opportunity    |
| Raymond Dart                    | Social entrepreneurship is an encompassing set of strategic responses to many of the varieties of environmental turbulence and situational challenges that nonprofit organizations face today. <sup>9</sup>                                                                                     | Nonprofit innovation                | Opportunity    |
| Johanna Mair & Ignasi Marti     | Social entrepreneurship is defined as the innovative use of resources to explore and exploit opportunities that meet a social need in a sustainable manner. <sup>10</sup>                                                                                                                       | Social entrepreneurship             | Opportunity    |

professionalization of social entrepreneurs is gaining increasing attention as it is important for socially-minded entrepreneurs to also learn about the financial aspects of the business and to be trained not to just create but also manage and grow the business into a thriving and financially sustainable entity. This is important especially for the social enterprise to achieve its true potential in terms of impact and scale.

### Balancing Commercial and Social Goals

In terms of the intrinsic drive, vision, and aspirations, social entrepreneurs do not seem to differ much from their business counterparts. Yet, in addition to the challenges faced by business entrepreneurs, social entrepreneurs encounter



Drive, vision, and aspirations of business and social entrepreneurs are not that different.

another set of issues pertaining to their social objectives that add an extra layer of complexity to their activities. The key challenge in social entrepreneurship is managing this double bottom line of having social and commercial aspira-

tions. Often, this has the potential to create difference of opinions within the management about the business. In fact, it can be stated that this apparent conflict between social and commercial priorities is a central characteristic of social entrepreneurship.

Thinking about entrepreneurship has expanded beyond just high technology and/or business activities funded primarily by private and venture capital funds and not-for-profit activities funded primarily by philanthropic foundations to contemporary ideas and concepts that help address the social needs of individuals worldwide. The issues extend from food and health to education and housing and other key determinants of a robust and growing society. These activities are funded by new partnerships between the government, private capital funds, philanthropic foundations, social movement organizations (SMOs), and the public in general. The idea is to create a strong public-private partnership that will enable the private sector and the public sector to cooperate and learn from each other. As opposed to private enterprises where the lines of accountability are reasonably clear, accountability is often a complex issue for social enterprises. Specifically, by taking on a social mission on behalf of a particular constituency, social entrepreneurs create an additional stakeholder, which they must take into account and communicate with them building the venture and developing its strategy.

The influence of venture capital money or grant awards is likely to have intentionally or otherwise created pressures and incentives for the entrepreneurial organizations to foster increased professional behaviors among the founders, rational decision-making approaches, explicit structure of organization, and explicit project management approaches. This may have further created the need for entrepreneurial organizations to be focused on project-specific short-term measurable outcomes rather than broad-based social-impact oriented commu-

nity projects. From this perspective, increased capitalization and funding needs result in an eventual shift towards moderate and low-risk goals and strategies. As a result, the more radical and indigenous projects and ideas may well be neglected or even abandoned. In fact, social innovations in general primarily focuses less on radical and/or risky innovations and more on imitation and incremental types of innovation in order to enable social innovations which have succeeded on a small scale and to help them have a far greater and wider impact. So far, scholars seem to have paid only passing attention to the causal mechanisms that account for how capitalization needs might translate into a new trajectory of movement activity.

### Select Examples from CEE

**Ashoka-Hungary.** Relaunched in Hungary in September 2011 and based at Central European University's InnovationsLab, Ashoka-Hungary is part of Ashoka, a global organization that seeks to empower local social entrepreneurs to bring out positive social change in the region and community they live in. Through an extremely competitive and highly selective admission process, the Ashoka Fellows once elected are provided a monthly stipend and the professional resources needed to focus on their aspiration of being a change maker in their societies. Currently Ashoka Fellows operate in about seventy countries around the world.

**NESsT.** NESsT is an organization that helps social enterprises grow their operations by focusing on both their financial impact as well as their social impact. Focusing specifically on emerging markets, NESsT has been present in CEE since 2001. The organization has thus far helped well over a hundred local and regional social enterprises by providing them with the professional resources required to grow and scale their operations.

**Fruit of Care.** This Hungarian-based social venture works primarily with people with mental disabilities and provides them with the training and skill set required to design and create locally crafted products such as t-shirts, handbags, jewelry, etc. Fruit of Care operates about eight housing centers in Hungary where the people are trained and also taught the business aspects of the trade.

### Discussion + Going Forward

Entrepreneurship seems to be constantly evolving, expanding, and adapting itself to accommodate new and diverse forms of value creation such as social entrepreneurship. There appears to be a hybrid spectrum of entrepreneurial activities prevalent in the modern economy. These range from traditional not-for-profit activities to traditional business/commercial-oriented activities. What distinguishes social entrepreneurs from everyone else is that they see their job as changing the overall patterns and systems of society. To this extent, unlike conventional entrepreneurs, social entrepreneurs rarely allow the external environment to determine whether they will launch an enterprise. It can further be

stated that social entrepreneurship is about “explicitly aspiring to solve a major societal problem with professional management and business efforts and, indeed, enable the creation of widespread social change.”<sup>14</sup> Based on the examples listed in the previous section, there seems to be evidence that social entrepreneurship is an emerging field creating positive impact in CEE.

It can also be summarized as a temporal continuum which transforms new ideas into development, development into implementation efforts, and implementation efforts into scale-up expansion activities. In certain cases, an organization may not be definable as a socially entrepreneurial organization until it faces the management conflicts of balancing the double bottom line. I predict that over time upstart not-for-profit social enterprises will be more focused than before on generating a sustainable income. Conversely, there is much for business/commercial entrepreneurship researchers to learn from the social entrepreneurship context. There is still considerable research to be done to fully understand the new strategies, concepts, ideas and organizations that will emerge from the trend of adopting a businesslike approach to social causes. It will require studying the field in close detail and its relation to existing literature in innovation management. Currently, social innovation and entrepreneurship is becoming increasingly important within the academic debate, also regarding its theoretical concepts.

For social innovation and entrepreneurship practices to gain an even more widespread acceptance, we need some further development of the paradigms based on which we determine whether a given social innovation is a success or not. In business/commercial entrepreneurship there is a clear measurement for success—the financial bottom line. However, it is much harder to measure impact in the social sector. A key area of future interest will thereby be the concept of Social Return on Investment (SROI) and effective ways to measure the social impact of both entrepreneurial activities and the public spending. This will be an exciting topic for researchers to study.

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Bernadett Koles

Chapter 2.7.

# A NEW GENERATION OF DIGITALLY EDUCATED WORKERS

## CHAPTER IN BRIEF:

- ▣ Virtual connectedness, activeness, and immersion of today's youth will affect the future organizational landscape.
- ▣ For the under twenty-five segment of the population, Internet and social networking penetration rates are similar in CEE and the West.
- ▣ Innovative technologies allow current youth to transfer skills and competencies from alternate realities.

A pair of young entrepreneurs from Iceland recently set out—with the help of a small grant and a great deal of ambition—to discover what it takes to become a successful entrepreneur. They had their own stories, but they wanted to know about those of others. Throughout their quest, they interviewed young entrepreneurs from around the world with one or more successful ventures under their belt, many of whom are showcased in the documentary *Startup Kids*.<sup>1</sup> You may think that these stories resemble numerous entrepreneurial adventures launched in the past; and in many respect, you may be right. Plus, you may wonder, how relevant are these examples anyway, coming mostly from the field of IT? Most of us would agree that high tech firms are distinct and one of a kind entities, expected to differ in many—often fundamental—ways from our more traditional organizations. Consider Google, Inc., for

example, with its well renowned unique culture, flexibility, and highly creative employee pool which attracts a particular sort of talent.

Yet there is something strikingly different about this current documentary group. Think of Brian Wong, who founded Kiip at the age of nineteen, enabling him to become one of the youngest entrepreneurs to receive venture capital; Zach Klein, who founded Vimeo at the age of twenty-two; Drew Houston, who founded Dropbox at the age of twenty-four; or Mark Zuckerberg, who in 2003, at the age of nineteen, launched Facemash, the predecessor of the well-known social networking site Facebook. Or to name an example from Central and Eastern Europe, think of Prezi, the original and creative cloud-based presentation and storytelling software founded by three young Hungarian entrepreneurs in 2009, with recent global usage statistics documenting over 30 million customers. Again, we can list many examples of past success stories where talented and driven individuals made it big while young. But most of these showcased entrepreneurs are teenagers and young adults, some barely even out of high school. And what is perhaps even more interesting, for most, is that these well-known successful ventures were not their founders' first entrepreneurial engagements.

Of course, sufficient talent and ingenuity can take you a long way, given the right circumstances. Think of the fifteen-year-old Kelvin Doe, native of Sierra Leone, recently invited to MIT for a few weeks to work alongside faculty members and researchers. Without any formal training in engineering, Doe was recognized for his inventions; for creating generators and batteries out of scrap materials to power his neighborhood, and for broadcasting news and music via his self-made RF transmitter. You may think that Doe's success story may have been just the same a few decades ago—a young boy with talent, enthusiasm, and courage, at the right place and time to be discovered. But consider the following two points. First, Doe is quite unusual in comparison to most teenagers growing up in developed societies, exposed to abundant supplies, connectivity, and an available network. Second, during the first two weeks following the release of a brief film documenting Doe's story,<sup>2</sup> the video attracted over 3.4 million viewers on YouTube.

The point is, while not all of today's youngsters will become the future Zuckerberg, Klein, or Houston, it is not as remote of a possibility as we may think. In our increasingly networked society, with a computer or laptop and an Internet connection, you can practically do anything you want; and clearly, many do. We may only hear of a select few today, but most of us are likely to encounter many of them in our organizations in the near future. My question to you is: Are we ready for them?

In this chapter I highlight certain important features which characterize this digitally immersed group that will compose our future employee pool, and invite you to consider the potential impact they may have on our organizational landscape. The next chapter will further analyze this question in the context

of rethinking current teaching methods and curriculum to train digitally educated workers. Let's begin with a brief overview of certain basics characterizing our current and increasingly digital environment, in order to see the role of the World Wide Web and different cyber platforms on individuals, businesses, and society at large.

### Why It Matters

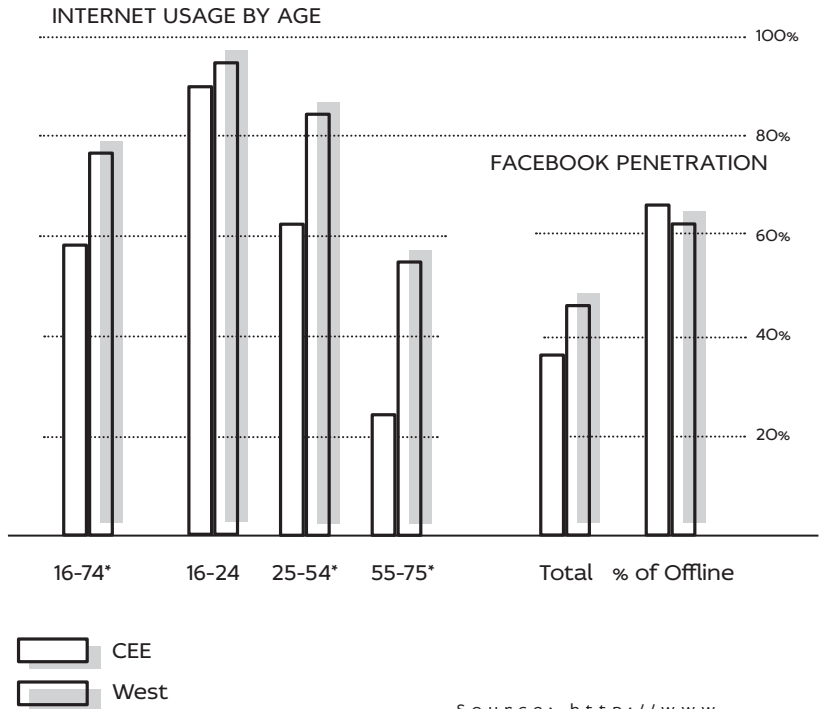
The Internet has modified the ways in which we communicate and approach information. Undoubtedly, the numerous Web-based platforms that emerged within the past decade, including social networking sites (SNSs) and virtual worlds, enable individuals to connect and socialize with others in new and innovative ways. Beyond the merely social aspects, virtual environments represent a variety of other attractive features. In the case of SNSs, such as Facebook and Twitter, members can share a diverse set of content, including pictures, videos, posts, and updates, and engage in various collaborative applications. In the case of virtual worlds, users are able to interact with one another in an immersive three-dimensional space, achieving their presence through their avatars or virtual self-representations. In these settings, such as *World of Warcraft* or *Second Life*, the environment, the objects, and the characters are entirely user generated, leaving a great deal of freedom and flexibility at the users' discretion.<sup>3</sup> Many of these virtual worlds have fairly sophisticated economic systems, enabling employment, monetary transactions, and property ownership. Several new virtual worlds are emerging, targeting different age groups, and while many maintain a minimum age for registration, more recent ones are moving toward the younger user pool, as young as five years of age.<sup>4</sup>

Internet penetration has been increasing steadily over the years, with the spread and accessibility of laptops, mobile phones, and tablets making it easier for individuals to stay connected to the World Wide Web. People's motivations to use the Internet may vary, ranging from occasional usage to practically constant access. Given the relative novelty and complex evolution of Web-based platforms, along with the likely impact of wealth and economic factors on Internet penetration, we need to approach corresponding statistics with caution. As an illustration for this, and considering the core focus of the current compilation of work on CEE, Figure 2.7.1 presents Internet penetration as a function of age, and Facebook penetration as a function of scope, separately for CEE and Western societies.

As the figure shows, the overall daily Internet usage is significantly lower in CEE, perhaps at least in part attributable to economic factors. When we consider the age distribution, it becomes clear that the significant overall difference is carried by the over twenty-five segment of the population, with no difference in the sixteen–twenty-four age bracket; with the latter group showing universally high usage rates. Similarly, when we consider Facebook penetration for the population as a whole, the CEE countries again fare worse. But when we

Figure 2.7.1.

Internet and Facebook Penetration by Age and Scope of Usage<sup>4</sup>



\* signals statistically significant difference.  
Source: <http://www.socialbakers.com/facebook-statistics>

account for the already identified differences in general Internet usage, and thus consider the Facebook penetration of the online population only, we find that the difference between CEE and Western nations disappears. These data illustrate that despite population level discrepancies, younger generations tend to be equally connected and exposed to the Internet and to its applications, regardless of geographies.

How about general usage patterns on these platforms? Are these digital innovations really prevalent, or are they just serving as a pastime activity? Let's consider some further statistics. The population frequenting SNSs and virtual worlds has been increasing exponentially worldwide, with Facebook recently announcing to have reached one billion active members.<sup>5</sup> Regarding virtual worlds, reports estimate the total number of accounts to be around 1.4 billion; an intriguing value, even if we take into consideration that some users may be represented by more than one profile. In terms of online games, the gaming

industry can account for 183 million active users in the United States, 15 million in Australia, 17 million in South Korea, 10 million in Mexico, 13 million in Central and South America, to name a few regions. In Europe alone, there are 100 million online gamers, and while many tend to spend only an hour or two per day gaming, about 10 percent of them spend as much as twenty hours a week, or even more in the case of extreme gamers.<sup>6</sup>

In her recent innovative and thought provoking book *Reality Is Broken*,<sup>7</sup> Jane McGonigal, an American game designer specializing in alternate reality games, introduces certain gaming-related trends which are likely to shape our world in several ways. For instance, by the age of twenty-one, an average American will have spent around 2,000–3,000 hours reading books, compare to over 10,000 hours playing video games; about the same amount of time that a student spends in the classroom from fifth grade through the end of high school, assuming perfect attendance. But what's the appeal? McGonigal suggests that games in today's society enable us to fulfill genuine human needs, which the real world is currently unable to satisfy. What's more, she proposes that unless we change something dramatically, our society may become one in which many members will choose to seek out online environments for memorable events, rewarding experiences, and accounts of success.

So what can we do? The first step is to think about virtual environments in a positive light, as opposed to being a waste of time and distraction from what is real and important. Of course, excessive online presence may have its share of negative consequences, including addiction, which should not be ignored. Clearly not all online users fall prey to these potential dangers. For many, the opportunities for learning and development likely to emerge from their participation are enormous. I now turn to discussing a few relevant aspects associated with online existence, which may help us understand the current digital generation more fully. This question may be approached from a variety of angles, but here I focus on three particular dimensions; namely the existence of *two realities*, the notion of *transferability*, and the concept of *prosumption*.

### One Reality or Two?

Non-gamers often make rapid judgments about the value of online environments, continually questioning how and why so many individuals—particularly youngsters—can spend much of their time on these platforms. Several such skeptics may be influenced by their own personal experiences with computer games from decades ago, may feel uneasy about the whole notion of alternate realities, or perhaps struggle with more basic Internet applications, and are left unable to imagine anything constructive emerging from these encounters. Driven by similar assumptions and prejudices, many of us revert to assume that virtual encounters are a waste of time, a distraction, or an escape from day-to-day life; and whichever it is, most definitely harmful. But let's take a different point of view. Even if virtual settings serve as a form of escape for some users,

we should not generalize widely, as the reasons and motivations of individuals have been shown to be quite diverse.<sup>8</sup> In fact, being intrigued by the options and possibilities available in these alternate realities can be sufficient for many users to join and maintain their online presence.

Regarding the question of reality, while we may have our own doubts, for the inhabitants and gamers themselves, these virtual environments are completely real; they provide unique challenges, rewards, sources of gratification, opportunities to interact, to create, and above all to learn, in a manner which is more immediate and accessible than in many real world settings. By the act of creating an account, and thereby establishing an avatar, users are able to embody their presence, which they can modify as frequently or infrequently as they wish. Many elements surrounding the avatars feed from our real physical world, including advertisements, well-known brands, cities, and even educational institutions. Our avatars can wear Nike shoes, see ads for Subway or McDonald's, attend a U2 concert, or study at Insead's virtual campus; all within an environment that looks and feels realistic. To ease the transition between the two realities, even when users are offline for a period of time, life carries on in these persistent virtual worlds, similarly to when we go to work or run out to the store. Even scholars increasingly began to refrain from using *real* versus *virtual*, given the potentially misleading connotations; and instead revert to using *offline* versus *online*. This reflects on the novelty and constant evolution of digital environments, with many of us trying to come to terms with what they mean for us and for the users.

### Distinct or Transferrable?

For many individuals the primary motivation of joining a virtual environment lays in factors related to socialization, fun, and entertainment. Yet for many others,



Digitally immersed youth possess skills far beyond their level of formal education.

these communities also represent a source of work and income. For example, YouTube rewards those users whose uploads exceed a certain number of viewers. In certain games, like Diablo 3, players are able to sell virtual objects to

each other for real money. In Second Life, inhabitants can become the proprietors of clubs or shops, presenting them with real monetary benefits.

In addition to the direct consequences, virtual activities may provide certain indirect benefits for their users. Many of the skills obtained in virtual environments were shown to carry over to skills and competencies in real life settings. Literature based virtual environments are a good example, where following their engagement in extensive writing targeted to a more select audience, individuals can go on to become writers in their professional lives, with a vast amount of practice behind them. Similarly, given that the language of most virtual environments is English, individuals gain an opportunity to practice and advance their

knowledge, making themselves more competitive in our increasingly global marketplace. Finally, virtual world users successfully practicing a certain profession, such as being a digital artist or fashion designer, often succeed in a more global scale outside of the virtual setting.

### Consumers or Producers?

The notion of *prosumption* dates back to the 1980s, referring to the increasing ambiguity and blurring between the acts of production and consumption. The concept of *production for self use* enabled individuals to take matters related to their own health, preferences, and aspects of their physical and emotional well-being into their own hands, rather than relying solely on experts.<sup>9</sup> The prevalence of prosumption has been increasing ever since, given the fertile grounds provided by cyber platforms.<sup>10</sup> As Web 2.0 and Web 3.0 environments depend predominantly on user-generated content, and thus foster various forms of co-production, teenagers and young adults are frequently exposed to situations where they collectively build their environment, the content of their site, and produce materials that they in turn consume, along with other members.

The implications of prosumption are numerous, with a few particularly worthy considerations. On the one hand, *expertise* is likely to shift from the traditional sense toward a more diluted and inclusive construct. In fact, anyone in these environments is able to make a value-added contribution, regardless of real life status, background, or formal education. On the other hand, we may need to revisit our traditional understanding and approach toward *motivation*. Many of the users on these online platforms are willing to invest a lot of their time to the design, establishment, and further development of content, with their engagement driven primarily by factors that are intrinsic rather than extrinsic in nature. From this perspective, it is quite difficult to imagine these youngsters to flourish and live up to their potential in our more traditional organizational settings; ones that are based predominantly on hierarchy, status, formal education, extrinsic reward, and monetary gain. These individuals may excel in their online environments, where they can be active, productive, and creative members of their communities, yet may struggle in offline settings.

### The Way Forward?

With this brief review, we highlighted certain relevant features associated with our increasingly digital culture, and its role for the younger generation. Furthermore, we saw how these innovative technologies can bring the *global* right to the *individual*, regardless of otherwise prominent physical, cultural, or geographic boundaries. In fact, while prevalent in most societies, Cyberspace may have an especially pronounced impact in particular nations, where the financial, structural, geographic, or socio-economic environment differs from Western societies.<sup>11</sup> CEE provides a good example for this, with a pool of about 136 million Internet users as of 2011,<sup>12</sup> opening up various interactive opportunities

for social media sites and virtual worlds. From an individual perspective, CEE residents can take advantage of Web 2.0 platforms to engage in social and economic activities, or undertake non-traditional forms of self-employment. From a business perspective, virtual environments represent financially open, secure, and economically flexible settings that impose fewer rules and regulations when compared with offline realities.<sup>13</sup> These characteristics enable CEE-based organizations and startups to tap into the regional as well as the global market more easily, and to be less confined by the availabilities and limitations of local demand.

So what is the central message? Online games and virtual environments hold immense benefits for us, academics or practitioners, young or old, from the East or from the West; as long as we approach the matter with an open mind. And that means approaching the current generation of digitally immersed youth with an open mind as well. By the time they join our organizations, they are likely to possess a variety of skills that reach far beyond the expected knowledge and abilities assuming their level of formal education. They may not excel to become one



Why don't we find ways to incorporate their unique skills into our business practices?

of those entrepreneurs showcased in Startup Kids; yet many will have their own successful adventures using innovative technologies, and the skills they acquire would be a waste to ignore. Yes, they may have alternative and to many

of us unusual lifestyles, choosing to spend many of their waking hours online. We may disagree with them on the boundary between real and virtual; or we may struggle to imagine how their virtual skills may transfer to our organizations. Rather than shutting them out due to preconceived ideas, why don't we try to understand them better? Why don't we find ways in which to incorporate their unique competencies into our business, in order to collectively create a more prosperous, sustainable and constructive work environment?

Needless to say, we have a long way to go. The journey holds immense opportunities for innovation, creativity, and constructive cooperation between numerous disciplines; yet the exact steps to success are unknown. A recent review in *The Economist* exploring *gamification*—the application of gaming techniques and situations to non-game settings—suggests that the world inarguably would be a better place if work was less of a necessary drudge and more of a rewarding experience in itself.<sup>14</sup> The article concludes that this goal remains difficult to achieve, and that perhaps work is called work for a reason. But think about what we have just reviewed about the current young generation; is separating *work* and *play* likely to remain sustainable?



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Tibor Vörös

Chapter 2.8.

# BACK TO REALITY: GLOBAL TRENDS IN BUSINESS EDUCATION

## CHAPTER IN BRIEF:

- ▣ With the modern economy becoming increasingly knowledge-intensive, business schools need to re-examine their curricula.
- ▣ Business students gain immersive experience from solving actual business problems; this helps in the practical application of formal knowledge.
- ▣ A new breed of business simulations provides a flexible medium that enables active experimentation mixed with reflective observation.

**B**usiness education has become a very popular concept in recent years and, in fact, many colleges, universities, private business schools, and professional organizations now all offer business education classes. Individuals consider applying for the Master of Business Administration (MBA) degrees at various stages of their careers. Apart from the vague impression of learning about “something to do with business,” what do we actually expect from “business education”? Does it refer to knowledge and skills needed by would-be entrepreneurs? Or to gaining practical exposure to business management, thereby becoming a better leader through class experience? Or is it that business education is simply a ticket to higher earning power and better career prospects?

The unique skill sets possessed by the generation of the digitally educated workers should, as Bernadett Koles postulated in the previous chapter, affect

and managerial decision making. By the same token, the growing importance of these skills may also require changes in educational technology and methodology. To be sure, individuals have different needs and expectations to which educational institutions cater accordingly. But beyond these idiosyncrasies there are some common themes and this chapter aims to highlight and discuss some shared challenges in the business education arena at the outset of what we can call the age of digital education.

In its most general form, business education refers to a variety of courses designed to provide participants with any number of skills, theories, and frameworks needed for success in the business world. The first formal business education degrees were introduced in the United States in the 1880s. By 1902, there were a variety of Master of Science in Commerce degrees, and in 1908, Harvard University offered the first MBA program. Over a hundred years later, in the United States alone, more than 100,000 MBA degrees are awarded annually, representing roughly two-thirds of all graduate business degrees conferred.<sup>1</sup>

In contrast to the well-established nature of business education in the Western world, the socialist economy in CEE did not promote entrepreneurship and business-savvy approaches. Consequently, MBA programs only began to appear in the 1990s in a handful of regional centers and universities (e.g., IEDC-Bled School of Management in Slovenia, Warsaw University of Technology Business School in Poland, or International Management Center in Hungary). The transition from a socialist economy to a market economy represented a key challenge in the region. This can be highlighted not only in terms of economic liberalization measures and major institutional changes (see Chapter 2.2), but also by requiring different mindsets and managerial approaches (Chapters 1.6 and 2.6). International business programs were struggling to tailor their content to the local issues and legacy of the Soviet-style systems.

In sum, the relevant content of business education has changed considerably over time. Market demands, regional practices, and trends do affect business education programs, dictating to some extent the kinds of classes, theoretical frameworks, and practices offered. Key aspects of business, such as accounting, finance, or marketing were always considered cornerstones of business education; while, communication skills, cross-cultural collaboration practices, and approaches to innovation have been added due to globalization and changes in the business climate.

### **Tacit or Explicit Business Knowledge**

Following the above definition, business education should include both explicit and tacit knowledge. Formal or explicit knowledge—for example guidelines to a business plan—can be written down, transmitted, and understood by the recipient with relative ease. However, writing a successful business plan, in terms of capturing the interest of investors or outlining an implementable and realistic plan, is a very different issue and usually requires considerable practical

knowledge that is more difficult to transfer, and is therefore contained within the tacit knowledge domain. One of the key methods to acquire tacit knowledge is shared experience. As tacit knowledge is difficult to codify or describe in words, a shared experience is one of the best ways to acquire such knowledge, but it may be limited either by the timeline of the business education or by the availability of relevant organizations and partners.

Thus the question naturally rises, can we codify and teach tacit business knowledge? Considering the volumes of texts published and used in business education, there certainly have been attempts to accomplish this Sisyphean task. We could also consult with managers of Fortune 500 companies (assuming we actually managed to find a company that would stay on this list long enough). This annual list, compiled by Fortune magazine, ranks the top 500 U.S. corpora-

tions based on their adjusted gross revenue. The first list was published in 1955 and although the methodology has changed over the years (e.g., service companies were not included prior to 1994), it presents a relatively consistent

evaluation of success and failure throughout the decades. If codifying business knowledge, and therefore measured success, were that easy, then half of the companies who have fallen off Fortune's list in the past ten years would, in all likelihood, still be successful.<sup>2</sup> Thus, we can conclude that although there are frameworks, theories, and ideas, the application to specific situations requires tacit knowledge that makes a manager and an organization successful.

Business education typically incorporates many different disciplines, such as finance, marketing, or operations management. Understanding how each subject fits into the whole and relates to the others is essential to being successful in business. Due to this compartmental nature, business education can lack integration, with tendencies to discuss accounting, finance, and marketing-specific problems separately. Graduates may feel unprepared and unequipped when they face complex real life interdisciplinary business problems. In addition, interacting with the relevant business units and departments may not be as straightforward as envisaged in the classroom. This is by no means a new issue,<sup>3</sup> but one that is becoming increasingly prevalent in our inter-connected world of globe-spanning ventures. Further, as both local and global ventures are affected by changing legislation, greater emphasis in education on the extended business environment becomes more critical.

In sum, participants should have an immersive experience where they can try solving various business problems firsthand; this would help in acquiring tacit knowledge and support the practical application of explicit knowledge. In addition, this experience should be an integrative process, where subject silos invariably depend and interact with one another and problem solving must look beyond single functional business units. Although the existence of local mana-



Can we codify and teach tacit business knowledge?

gerial practices is a global issue, it is particularly relevant in the CEE region. The question thus can also be expanded to incorporate the local managerial practices and both expose and force managers to recognize advantages and disadvantages of local approaches.

As business education has matured, various approaches have been employed to address the aforementioned educational problems and objectives, ranging from action learning, also known as cooperative learning, to simulations. Other tools have notable advantages and valuable merits, but a new technique of simulating potential business scenarios for executives and managers may be superior due to its potential to engage students and provide a specific scripted scenario for testing students in these environments.

### **A New Breed of Management Simulations**

Management simulations and business games appeared as early as the 1950s in business education. Many of the early simulations were specific to pre-defined scenarios and required specialists to modify the original scripts. Recently, a new breed of management simulations has appeared representing a very different approach: online, storyboard-driven management simulations, incorporating complex business logic.

As an example, let us look at a management-level business simulation tool based on a computerized engine developed by Cesim Ltd., which uses a storyboard written by the author of this chapter. The simulation is the basis for a course, known as The Boardroom Exercise, at CEU Business School. The course has been a mandatory part of the MBA curriculum since 2008, and in 2010, I received the CEE-MAN Award for the simulation.<sup>4</sup> Participants of the course act as managers of fictional mobile handset manufacturing organizations, competing in American, European, and Asian markets. Participants have to make decisions about key managerial issues based on financial statements and patterns of consumer behavior provided by the simulation while competing against each other based on financial success, which is defined by dividends and final share price after six–eight rounds. In simulation time, each round (usually one week in real time) represents a year, and thus participants experience leading an organization for a six-to-eight-year period. A unique element of this simulation is the customization available to the simulation leader; the program's parameters are flexible and can be modified at the leader's discretion. Here is an excerpt from our unique storyline, which was written following the onset of the 2007–2008 financial crisis. Parameters of the simulation engine were set to match the corresponding storyboard:

Unexpectedly, the collapse of a global housing bubble peaking in the US caused the values of securities to plummet, damaging financial institutions globally and having widespread effects on economies. Leading specialists are calling the current event the worst financial crisis since the Great Depression of the 1930s. Economies worldwide are

slowing down as credit is tightening and international trade is declining. The worst effects are expected in the US, with over 10% decrease in demand. The picture is similar in Europe, where consumers locked into 12 to 24 month contracts are unable to upgrade and price-sensitive buyers are shopping around for cheap solutions. In Asia, weak consumer confidence and poor replacement sales coupled with price increases will probably result in some decrease in demand as well, although, so far, the Asian economies seem more resilient. As a consequence, Tecno Analytics Inc., a research group, believes Tech 2 is still attractive, particularly in Asia. From the technological viewpoint, due to sudden breakthroughs in network technology, Europe and the US are now able to support Tech 4 mobile phones. The R&D expenses for developing the new technology are believed to be enormous.

Participants test their skills in a simulated economic crisis, and can try various strategies to deal with difficulties. The simulation allows demand figures to be modified and market conditions to emulate a shortage of credit, among many other possibilities. Certainly, the underlying business model cannot replicate the real markets, but it provides a dynamic learning opportunity that would be very difficult to imitate with any other methodology. This approach provides a flexi-



Business education is not always aligned with business reality.

ble medium that enables active experimentation and provides concrete experience, mixed with reflective observation and conceptualization of the findings. The effectiveness of such a blended approach has been supported by experi-

ential learning theory popularized and tested by scholars such as David Kolb. Capabilities and qualities of modern business games include computerized behavioral simulations, complex economic models and business environments, storyboards to test specific business situations, and many other elements. They should become key supporting components of business education as they provide flexible educational tools and solutions in our changing world.

### **The Elephant in the Room**

Although simulations can help participants prepare for unexpected situations and practice decision-making roles and approaches, the actual application of the knowledge gained in business education—be it tacit or explicit—is more difficult.<sup>5</sup> Despite all the theories and practices, business education is not always aligned with the business reality that will be experienced by its participants.<sup>6</sup> Further, practices and behavioral models learned in business education, despite their relevance, may not get implemented in daily practice. This is partly related to the way in which humans naturally make decisions and how we tend to fall back onto old (usually heuristically based) solution frameworks.

Current studies have highlighted the dualistic nature of mental processes which, incidentally, may have profound implications for our managerial decision-making approaches. Using the terminology popularized by the Nobel Prize winning behavioral economist Daniel Kahneman, human reasoning can be carried out through two distinct cognitive systems. System 1 cognitive processes occur spontaneously, they are automatic, implicit, and usually heuristically based. Recognizing that the face of the person entering the classroom belongs to a certain professor is a typical System 1 process. Solving a complex mathematical equation (which does not have an intuitive solution) requires a different system, bringing us to System 2.<sup>7</sup> This is characterized by conscious analytical efforts and explicit reasoning. The difference between these two systems (and the cost of using these systems) is succinctly highlighted in a simple experiment called “the bat and the ball.”<sup>8</sup> Participants are asked the following question: “A bat and a ball together cost \$1.10. The bat costs \$1.00 more than the ball. How much does the ball cost?” An intuitive answer that springs quickly to mind is 10 cents, a typical System 1 type approach. Provided that you catch the error used in this logic, a System 2 type approach can be used to provide the correct answer of 5 cents. But the key issue is that using System 2 requires an extra effort. Jonathan Haidt contrasts the two systems in a very powerful metaphor:

The mind is divided in many ways, but the division that really matters is between conscious/reasoned processes and automatic/implicit processes. These two parts are like a Rider on the back of an Elephant.<sup>9</sup>

This highlights the need to apply the experiential learning paradigm and to make a conscious effort (as a Rider using a System 2 type approach) to override the intuitive answers given by the Elephant, who uses the System 1 type approach. Simulations can help in understanding typical pitfalls demonstrated by the bat and ball example, but participants of business education need to understand the extra effort required in a managerial environment that would result in the Elephant and the Rider working together rather than against each other. A wheel-spinning, over-analyzing Rider, with all the analytical management frameworks at hand, will bring no more change to an organization than an intuitive Elephant finding all the required water holes with simple heuristic rules.

Finally, what is the purpose of these systems? Why do we reason? Humans are highly developed social animals and the argumentative theory of reasoning emphasizes that the motivation lies in the rewards for social competence.<sup>10</sup> This theory concludes that our reasoning abilities have developed to bring us toward conclusions that we can justify to others; conclusions and decisions for which we can easily find supporting arguments. Accordingly, experiments have found our reasoning to be confirmation biased; people have a tendency to look for supporting arguments. Again, in some cases, this bias will work against newly minted graduates of business education; the theory or practices studied may not pro-



vide the supporting arguments that are easily accepted by other members of the organization and would require additional effort to implement.

In conclusion, during the age of digital education (and, more generally, in the



Today's managerial training cannot end upon leaving a classroom.

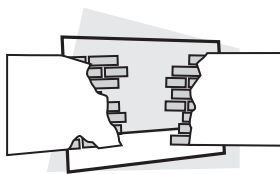
knowledge-intensive economy), managerial training does not end upon leaving the formal classroom; it continues and extends into daily business life. Among other tools, the new breed of simulations is further preparing business

school participants for this period by enhancing their educational experience.

## NOTES

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## Chapter 2.9.

# BORDERS AND BEYOND: AUTHORS' DISCUSSION OF PART II

### CHAPTER IN BRIEF:

- ❏ Europe faces a choice between the old world with borders and the opportunities of the twenty-first century.
- ❏ The success of shale gas and the rise of social entrepreneurship show how crossing boundaries between government, business, and nonprofits can bring real change.
- ❏ The managerial mindset and hierarchical structures must transform if businesses want to adapt to the new global context.

**M**aciej Kisilowski: Welcome back to our faculty discussion. As Mel and I wrote in the introduction to this volume, Part II is about two distinct types of global trends which Central and Eastern European (CEE) managers should be aware of. On the one hand, we have region-specific trends, related to the future of Europe, China, and the United States. On the other hand, we have borderless trends, such as climate change, social entrepreneurship, or the increasingly important digital reality. I hope we can devote due attention to both types of these trends.

### Rigidity and Adaptation

**Mel Horwitch:** I think it were you, Maciej, who wrote the part of the introduction about the two types of trends. Because I'm not sure I agree with the distinction. I think the key problem is how big centers of economic activity and

innovation—United States, China, Europe—respond and adapt to what you called “borderless trends.” I mean, take the current situation in Europe—both in terms of the eurozone crises discussed by Paul (in Chapter 2.2) and the broader competitiveness problems outlined by Maria in the preview chapter. I think there is a perspective here that is not economic but rather strategic and it is centered on the notion of flexibility. That you get too big and you get too rigid. You can’t innovate, you can’t deal with change anymore and then something has to break. Something new has to come along to take its place. The creative destruction model.

I don’t want to take that too far. But there are a few data points. Romania, for instance, has been taking advantage of the fact that it is not in the eurozone, attracting manufacturing and experiencing a reverse migration. Poland is another example of a country outside the eurozone that has a strong booming economy. Then you get to a situation where maybe the whole model of the Union creates an economic straitjacket not allowing adaptation, not allowing to take advantage of the global economy, of global competition, and of flexible response to global challenges.

**Maciej Kisilowski:** Do I understand correctly that you are basically saying the whole European project may be faulty?

**Mel Horwicz:** I speak as someone who has been an admirer of the European integration, of Monet and Schuman and others, dealing with the problems of devastation in Europe from the two World Wars and all the terrible things that had taken place. But I believe that the idea of looking at Europe’s problems from a bureaucratic perspective is out of date. I’m saying that, maybe small is not beautiful, but that, perhaps, the scale is not always the answer. It is possible that if a framework is hyper-rigid, or at least when it has no sufficient flexibility in it, then it is going to break because of outside pressures.

## World without Borders

**John Shattuck:** As I understand you, Mel, you are basically talking about a world without borders. Europe, of course, has been fixated historically and even



The world is becoming less about hegemony and more about projecting the entrepreneurial spirit.

today with borders and unable to deal with that straitjacket for various reasons. Paradoxically, today even China and the United States are more about a “world without borders” than Europe is.

I agree that the world is becoming less about hegemony, about taking over broad spheres of influence, and more about projecting the entrepreneurial spirit, which has all kinds of problems associated with it, but it is certainly a world without borders.

**Paul Lacourbe:** In fact, in today’s China, there is consensus that a portion of the globe from Japan to England would remain firmly under U.S. control. China realizes it cannot challenge that control, so there are not many options left. That

is why I wrote (Chapter 2.3) about this idea of building railroads to connect with Europe. The New Silk Road is an example of how China tries to flexibly adapt to global realities.

**Paul Marer:** Three days ago, a journalist asked me whether, given China's success, it would have been better for Hungary not to adopt a democracy, but a dictatorship like Singapore and Taiwan. It was a rather dangerous question for me to answer. As a faculty member of Central European University, I was careful not to make any anti-democratic remarks! But it is true that when Japan started its economic ascent after World War II, it was actually under US occupation and it was actually a one-party system. For twenty years there was no politics. And then Singapore, Taiwan, South Korea were strict dictatorships in their early stages of development. Taiwan and South Korea allowed free elections after they became successful, but Singapore is still a dictatorship. In CEE, by contrast, free elections were allowed before enough material wealth was given to people. I don't want to draw any conclusions on whether free elections and freedom are good or bad, but this data is telling.

**Maciej Kisilowski:** I think we are all going a little too far with our conclusions. First of all, Paul, your examples have been selected based on a dependent variable, that is economic development. If you select it based on an independent variable—that is dictatorship—you will have many more dictatorships that have failed to develop their economies than those who have succeeded. In a sense, the correct response to your reporter would be that the dictatorship is a gamble, because it can end up like Singapore or it can end up like Nigeria.

**Maria Findrik:** Leaving reasons aside, it is important to acknowledge that Europe today is just not as important as it was thirty years ago. Europe has lost a part of its competitiveness and therefore I can understand why the United States perceives us differently. We lost our advantages in costs, geopolitically, and to a certain extent in education. Therefore, I think that it is very important to identify new areas and drivers that these two regions can use to strengthen their relations.

**Paul Marer:** I have to disagree here. I think it is a little bit of a stretch to say Europe is losing its competitive advantage. If you look at the Global Competitiveness Report, I think that five out of the ten most competitive global economies are in Western Europe. Of course, there are competitiveness problems within Europe. But Europe overall has a balance-of-payments equality.

**John Shattuck:** I think Europe continues to be a focal point of the globalization process. What interests me (in Chapter 2.4) is America's leading involvement with globalization and, in particular, its continued engagement with Europe on a host of economic and political issues. I wish there was another author—maybe you are the right one, Paul—who could outline similar global goals for China.

**Paul Lacourbe:** As I explained in my chapter, the majority of the 1.3 billion Chinese believe that China should become the center of the world. There is also a consensus that as long as China is ruled by Chinese, China will not fall

behind. It fell behind because it was occupied by the Manchus and now that the Manchus are gone, it is natural that China goes back to where it used to be before the Manchu invasions. There is this engrained sense of superiority among the Chinese people that as long as they are in charge of their own country, they will always be ahead.

**Maciej Kisilowski:** Well, that sounds very nationalistic to me, which in turn seems to indicate that it is not only Europe that may have temptations to reject the world without borders.

### **New Problems, Creative Solutions**

**Tibor Vörös:** That is why I think it is very important that we devote so much attention to global issues in this book. I mean, when you get to the end of the manuscript, you have all the pieces of a big mirror, and these pieces are a reflection of global issues. I don't think that we are trying to provide solutions to all these challenges; we are raising these issues and providing a background and some situational awareness that can be useful for a businessperson.

**Maciej Kisilowski:** And the perfect case study about this tension between the old world with borders thinking and the new challenges of the twenty-first century is Mike's piece about shale gas in Poland (Chapter 2.5).

**Michael LaBelle:** That's right, it is a mix of old geopolitical arguments and the new ones. Yet, at least in Poland, the "new" arguments have very little to do with climate change and much more with business. And business is looking at the price of electricity, or the price of gas, and unless it is a big company that says "let's have some wind," or "let's have some solar," it needs to hedge its bets. Today, 90 percent of electricity is coal. The CO<sub>2</sub> price may go up and Poland may not get an exemption from the European Commission. They really need to start hedging their bets; they need more gas in their electricity mix. And the shale gas will be an alternative to the Russian gas. For Poles, it is the question of economics and not the question of climate change.

**Bala Mulloth:** That is all great but it obviously carries some ethical baggage. Shale gas is produced through fracking, which cuts the rock. When we talk about climate change and the post-carbon economy, isn't there an inherent paradox to invoke shale gas? Shale gas still contributes to climate change. And you are talking about innovation through something that causes earthquakes.

**Michael LaBelle:** I had it easy in this chapter, talking about Poland. Because it produces so much electricity from coal, the gas is an attractive alternative from the emission's perspective. For your argument overall, we cannot quite get away from a carbon-based energy system, so natural gas offers an acceptable solution. As far as water pollution and earthquakes are concerned, the technology can develop quite fast. When it comes to shale gas and technology to extract it, you see a huge amount of innovation going on. This is funded by companies like BP and Shell, as well as by small firms. The process is going to become a lot cleaner in the next few years.



**Bala Mulloth:** Is shale gas a safe alternative?

**Michael LaBelle:** It is an alternative, though personally I would rather have something else. But in a practical sense we have a system that is highly polluting and carbon-based, and shale gas is at least a bit better.

**Mel Horwitch:** What is happening in Poland is quite fascinating. There is the collusion of all these different forces: green energy, the geopolitical situation, not being dependent on Russian gas. There is also nationalism: if you are not going to use Polish coal, you are going to use Polish shale gas. There is also this technological innovation of shale gas, which people involved in the climate change debate don't quite know how to handle. Because it turns out that at some level shale gas works, it has revitalized the American economy somewhat. The paradox of this, the new complexity, and the need to recalibrate is not emphasized enough.

**Bala Mulloth:** But the problem here is that there's a perception that shale gas is clean. And, in fact, shale gas is not clean at all.

### Crossing Sectoral Borders

**Stuart Durrant:** Another issue that Mike's chapter brings is this division of labor between government and nongovernment actors in addressing challenges like the climate change. In my field of real estate, environmental considerations are often addressed by businesses without any tangible or direct governmental support. Consider the certification bodies such as the BRE or LEED. They identify whether you build in accordance with sustainability principles. Then they give you badges such as gold, platinum, and so on, based how you perform. Already there is some evidence of a market premium attached to buildings with better environmental ratings, and that's not just because the operational costs are expected to be lower and leaner at some stage in the future. I think we start to see similar dynamics in the fair trade movement as well, whereby the supply

chain is exhaustively examined, so that abuses such as child labor are weeded out.

**Peter Hardi:** I think that Bala's contribution (Chapter 2.6) shows that the dynamics that you are talking about, Stuart, become an important global phenomenon, as illustrated by the kind of hybrid between charitable NGOs and market enterprises.

**Bala Mulloth:** Clearly, there is a lot of interest in this field. But the purpose of my chapter is mainly to clarify what the concept of social entrepreneurship really means. Because I see a lot of misconception here: is it nonprofit, is it for-profit? Is Google a social enterprise? The answer is no, because the company was established to make money through a search engine. The social impact is a secondary aspect.

**Mel Horwitch:** Ok, my question is what's driving this phenomenon. Is this like a ground-level approach, or is it something driven by real-life market considerations? It is something similar to the environmental movement?

**Bala Mulloth:** I think it is really a hybrid. It is a ground-level approach, but to be effective, you need public policy support. So it has to start from the ground up, but you cannot just start a company in social entrepreneurship and be successful without getting government support. Because what you are trying to do is to make a change. It is not just a software company; to be effective you need the support from the top. It is a coming together of the private and the public sectors in some way. John mentioned earlier the world without borders; here, we are talking about crossing borders of our business, government, and nonprofit sectors.

**Peter Hardi:** I think an important part of the story here is that state support of the third sector has been decreasing quite dramatically, especially with the omnipresent austerity. And these organizations have to find ways to survive. Becoming somewhat more entrepreneurial and market-based is one solution. So what the social entrepreneurship may really be doing is offering a way to survive for those NGOs whose fate is otherwise uncertain.

**Michael LaBelle:** I think that, in fact, this approach can be particularly successful in CEE. Because there is a distrust of capitalists here, people may be more willing to buy something from a social organization rather than from a big

company. Many Central Europeans buy bio-organic products, for instance. Even though they are not cheap and people have no money. But they still buy it. There are so many social problems here, with about 80 percent of the population

being poor. There is a huge space for business that could possibly provide social benefits while making money.

**Maciej Kisilowski:** I have a completely opposite impression. For me, part of the reason why social entrepreneurship became so popular in the United States is that the American society cherishes its business entrepreneurs. So you have



Social enterprises can be particularly successful in CEE.



business entrepreneurial sector that lends its legitimacy to the NGO sector through the concept of social entrepreneurship. In CEE, by contrast, entrepreneurs are considered thieves. Here an entrepreneur is a person who in the 1990s had communist connections, took over a privatized company, and now drives around in a new Mercedes with a big gold watch. But, perhaps, by promoting social entrepreneurship, we can trigger the reverse to what happened in the United States: building social legitimacy of business entrepreneurship by fostering social entrepreneurship.

**Peter Hardi:** I'm not sure I agree with this description; you would need some empirical data to prove your point.

**Mel Horwitch:** I think that one aspect of social entrepreneurship that needs to be emphasized is globalization. The fact is that it has started somewhere, and it's now spread all over the world, and we have all these movements and organizations along with branches of these organizations everywhere. And it is actually a movement that seems prominent in CEE, too. Maybe there is a lag, but it certainly exists.

**Maciej Kisilowski:** I think you are absolutely right. Whatever the meaning of "entrepreneur" in CEE is, some things will become important just because they are global trends, and because CEE—with all its constraints—is very much plugged into global reality. That's why, as Tibor mentioned earlier, we have the entire part of this book on global trends. And I think Bernadett's paper on digital workers (Chapter 2.7) is a great example of such a trend. So, if you don't mind, I'd like to focus on it now.

### **The New: Opportunities and Threats**

**Bernadett Koles:** Thanks, Maciej. And I think you are right. There are going to be cultural factors for sure, there may be some deviations, there are also economic factors and availabilities. But if we are looking at fundamental trends, like the percentage of online usage in the case of what my chapter is dealing with, it is getting very stable and consistent regardless of culture. And this fundamental direction and growth potential is what I think is most important for the purposes of considering managerial implications of any global trend.

**Paul Marer:** The takeaway from your chapter for me is that what most older people criticize may actually bring significant benefits.

**Bernadett Koles:** What I wanted to highlight is the incredible potential that we, the older generation, question and the younger generation doesn't. That is the key discrepancy. For them this is not a question, everything is at their fingertips. They operate naturally in these settings. Part of what I am talking about is that we really need to change the mindset of managers. If you try to put someone who has done some amazing things in an online environment, you cannot just ignore it. The traditional mindset of our hierarchical organizations is that these people won't be able to function properly in real life. That mindset must change. There is, of course, going to be a pushback because of the crisis and

other reasons. But, ultimately, organizations will have to become smarter and this is a good way for them to become smarter.

**Charles Mayer:** I think that the real issue is how the younger generation is going to train us. We are seeing it every day as educators. For example, we've had the last two faculty job interviews with people who use Prezi. You can see how big of a change from PowerPoint it is. And frankly, I've been driven to Prezi by my students, not because I wanted to get there. The students because of their background and their experience are going to help us to learn what is important and what isn't, but we have to be selective.

**Paul Marer:** So when I see the students with their iPads playing games, should I not be bothered?

**Mel Horwitch:** There is, in fact, a serious managerial issue behind your question. What does it mean—to use Charles's words—"to be selective"? Take the recent story about Melissa Mayers, the CEO of Yahoo!, who banned telecommuting. It brings the question of whether there are some benefits of actually



Are there some benefits for co-workers of actually being physically together?

being physically together. That is at least what she is saying, and you cannot exactly claim she is part of some sclerotic, backward-looking caste. But she's saying we're going to get physically together: no longer working from home,

no longer living in the virtual universe, no longer working in your pajamas. You actually have to come to work, you have to meet people. The underlying question is whether you can do everything in a digital universe or are you missing cultural dimensions for which you need the interaction. I think this is an important question.

**Bala Mulloth:** I've just read a report from Silicon Valley;<sup>1</sup> it says that all the tech executives send their kids to schools where there is no technology at all. The Mark Zuberbergs of the world are sending their kids to schools where there is only pen and paper. The belief system behind it is interesting.

**Bernadett Koles:** There is really no clear formula. Organizations and educational institutions are now just realizing that they need to do something. We are moving in this direction and it is going to take some time.

**Zoltan Buzady:** Tibor (in Chapter 2.8) discusses the practical side of this mindset, doesn't he? The Boardroom Exercise simulation heavily relies on technology to train our MBAs to react to real-life situations. Following Mel's healthy skepticism about virtual universe, I wonder about how much of this is *education* and how much is *edutainment*.

**Tibor Vörös:** I am not really in favor of the term *edutainment*. But education through games is acceptable. Have any of you driven a Toyota Prius? You have a small screen there, and as you save fuel, a forest is built on your screen. And it's not only trees; there are also birds and then the sun starts shouting that it wants more birds. So that's a motivational factor. The idea is not to make it effortless,

but to make individuals more motivated. When I look at our students and I see how they spend three hours trying to figure out what the demand curve is, I can't help but think that if I were to give them a demand curve and ask them to do a pen-and-pencil exercise, they would never complete it.

**Maciej Kisilowski:** I think that Bernadett and Tibor's chapters, as well as the concerns brought forward by Mel, show that the line between the topic of Part II of our book (global trends), and Part III (new ways of thinking), is very thin. Today's global trends bring about new ways of thinking—like Charles's students who force him out of PowerPoint esthetics and into the world of Prezi. But thinking is not only the result of socio-economic relations. It's sometimes an independent variable that, for whatever reason, pops up in the minds of brilliant people who later change history. And it is because of this independent role of ideas that, I think, Part III of this book is so important.

## NOTES

- <sup>1</sup> Matt Richtel, "A Silicon Valley School That Doesn't Compute," *New York Times*, October 22, 2011.





Yusaf H. Akbar

Chapter 3.1.

PREVIEW:

## THE WAY FORWARD

### CHAPTER IN BRIEF:

- ❏ For too long, CEE followed models of management, strategy, and public policy mechanically replicating the West.
- ❏ CEE enters a more complex and unpredictable period of transformation that requires intellectual rethinking across all domains of society.
- ❏ CEE managers must closely examine new intellectual complexity and look for ideas in places that might not appear obvious.

The third and final section of the book consists of six chapters that focus on the new ways of business thinking. Five of these chapters refer specifically to the Central and East European (CEE) context, and all tackle the issues of new ways of thinking about the issues pertinent to business managers operating in the region. On the surface, finding common threads across topics including cyborgs, environmentalism, leadership, legal positivism, entrepreneurship, and innovation is far from evident. That is perhaps appropriate as one thing is for certain about the new ways of thinking—that they are often diverse, and seemingly chaotic.

Yet, as I demonstrate in the remainder of this preview section, there are some important and interesting common threads that bind together the chapters included in this part of the book.

## CEE's Intellectual Dysfunctionalities

Mel Horwitch, Maciej Kisilowski, Davide Torsello, and Zoltan Buzady take a particularly critical look at the predominant approaches to business thinking that remain engrained in the region. In his chapter, Horwitch describes how CEE lacks many of the key characteristics of dynamic, high-growth economies. As he points out the dearth of coordination mechanisms, scale of operation, governmental innovation policies, and world-class business schools, it becomes strikingly clear that without change, twenty years from now, the region will



CEE remains peripheral within Europe and on a global level.

remain peripheral within Europe and on a global level. While the 2008 financial crisis and current eurozone debt difficulties may have exacerbated the dysfunction, it is implicit in Horwitch's analysis that the resolution of European

debt problems and a return to global economic growth will not guarantee CEE a place in the top tiers of the global economy. Rather, more radical changes are needed that are transformative rather than reform-minded. These changes must make use of the current economic slowdown as a catalyst for leapfrogging ahead of other parts of the world. There is a revealing oxymoron in the use here: "central and eastern periphery." By definition, *central* cannot be *peripheral*; but the frequent insistence in countries such as the Czech Republic, Hungary, and Poland on the use of the term Central Europe represents naive blindness to or even denial of the realities of the peripheral and limited role of the CEE region in the world today.

In Chapter 3.3, Maciej Kisilowski outlines dysfunctional aspects of the legal and regulatory thinking in CEE caused by an over-reliance on legal positivism that leads to perverse outcomes. The case of micro-size entrepreneur Joanna W. and her nightmare experience with the Polish criminal justice system illustrate this starkly. Kisilowski argues that if the region is to break out of this non-fact-based legal system, private sector managers will need to engage in advocacy for far-reaching reforms of the process and institutions of policymaking. The goal would be a system focused more closely on real-life consequences of enacted laws and regulations—what Kisilowski calls "legal functionalism," which reflects the complexities and nuances of today's business environment.

Kisilowski's critique of the rigid public-policy thinking in the region is complemented by Davide Torsello's analysis of the public discourse carried by CEE's NGOs and public officials (Chapter 3.4). To be sure, while Kisilowski—a lawyer—is not shy about sharing his strong views about the intellectual culture he criticizes, Torsello—an anthropologist—is very careful not to sound judgmental. But the picture that he presents is rather troublesome. On the one hand, the post-Soviet mentality of state bureaucrats is now further strengthened by the centralization and top-down approach brought by the European Union. Here, Torsello's empirical account supports both Horwitch's and Kisilowski's argu-

ments. On the other hand, the NGOs, instead of bringing social awareness about environmental challenges that the region faces, strategically employ the discourse of corruption to achieve their objectives. At the end, corruption—instead of becoming increasingly marginalized—continues to occupy the center of the CEE public discourse, twenty-five years after the fall of communism. Torsello frequently uses the notion of the civil society, which today is understood as the synonym to the sector of voluntary, nonprofit organizations. But, as Torsello points out, civil society has a rich philosophical tradition dating back to Aristotle, who envisioned a society where citizens take the intellectual responsibility for both governing and being governed. According to Horwitch, Kisilowski, and Torsello, Central Europeans are distinctly far from achieving that kind of society.

Zoltan Buzady, in Chapter 3.5, moves the discussion from the level of society to that of an organization. His starting premise is that the current generation of CEE business leaders—the “fast trackers” as he calls them—became successful largely because they were able to demonstrate to foreign firms who came to invest in the region that they had the skills and competency required to develop the emerging subsidiaries in CEE. Their success notwithstanding, these leaders failed to create an organizational climate that was supportive of the next generation of middle- and executive-level managers. Thus, while striving to develop individual-level motivation in the management cadre, they did not allow for an organization to support it. Buzady offers a serious alternative to this deadlocked managerial thinking, in the form of his Absorption-based Model of Leadership.

### **Global Intellectual Ambition for CEE**

Another thread that unifies the chapters is interdependence in a global context. On the one hand, we have authors who seem to assume that CEE managers and public policymakers are ready to adopt and effectively deploy the cutting-edge global frameworks of business thinking, economics, and regulation. Horwitch makes the case for setting global benchmarks for CEE innovation and entrepreneurship initiatives. Kisilowski calls for the appropriation and introduction of legal and regulatory practices popular in North America. Buzady offers a model that can help CEE organizations bridge the leadership gap between regional and world standards.

On the opposite side of the spectrum is Chapter 3.6, in which Jay Fogelman offers a thorough critique of one fashionable Western new way of thinking, namely behavioral economics. He is quite clear that he wants this critique to serve as a broader cautionary tale about the dangers of equating global ways of thinking with Western intellectual fashions of the day. I am entirely skeptical about behavioral economics as a new discipline. Its emergence as a sub-discipline of economics owes as much to the intellectual bankruptcy of mainstream economic theory as it does to the need to examine a new phenomenon of irrational behavior of financial markets. As Fogelman correctly points out, the idea that humans behave irrationally is well established and explained by other dis-

ciplines. The best behavioral economists can do is to formalize the irrationality phenomenon in the language used by academic economists. Thus, the revelation of irrationality in human conduct is as much an internal debate within the discipline as it is an opening to a multi-disciplinary dialogue.

In his fascinating narrative on cyborg trading in financial markets, Fogelman takes the reader into the realm of chaos and complexity. He makes a number of interesting analytical points, especially concerning the need to differentiate between descriptive and explanatory theories. Describing complexity does not help explain it, nor does it help with prediction. In an important simile to the naive revelation of irrationality in economic and finance theory exposed by Fogelman, the other chapters also discuss the way in which the CEE region has, to a degree, been naive in its wholesale acceptance of related conventional approaches to transformation to date. Indeed, the call for the proper appreciation of complexity may be the third thread in the chapters in Part III of this volume.

### **Complexity as the Focus of New Business Thinking**

From Torsello's observation (and implied critique) of a top-down approach to civil society formation to Buzady's assertion that the first generation of post-1989 top managers in CEE do not recognize or understand the needs of the next generation of managers (e.g., different sources of motivation and encouragement), it is clear that there is a rapidly advancing redundancy of ideas in CEE that requires urgent attention. The prolonged economic slowdown caused by the 2008 banking meltdown in the United States and the debt and bailout exigencies confronting the eurozone may fundamentally question the basis of a dominant Western model that was adopted in CEE as core to the transition process (leading to EU membership).

The rich description of global innovation as depicted by Horwitch also illustrates complexities from global to local; between public and private sectors and across industries, suggesting that attempts to develop innovative "super clusters" involves nuanced and detailed understanding of complexity on the part of all stakeholders, and by no means guarantees that it will be successful. Perhaps what is most thought-provoking in Horwitch's contribution to a discussion of complexity is that European attempts to make policy may not be necessarily the right level at which to emphasize such efforts.

If I compare Buzady's and Kisilowski's contributions, I detect a manner of frustration at the disappointing outcomes in CEE in the past two decades. In other words, in 1989 there was a great deal more optimism about the future trajectory of the region. Perhaps even some of the countries could emulate the economic performance of the core Western European cluster of economies. Yet dysfunction in leadership and in the law has held back the countries. In particular it has slowed down progress towards achieving excellence. Horwitch does suggest that there is a way out, but it is not an easy and obvious path.



If a path is to be found, it rests on understanding complexity. This, as highlighted in all the chapters, has a crystal clear implication: that past and even current “cut and paste” approaches to transformation in CEE do not fit the reality the region faces today. As Kisilowski suggests, legal positivism is rigid and seemingly incapable of addressing even the most basic and sensible procedures, cruelly illustrated through the flower shop case. As Buzady argues, leadership models in CEE need to address much more subtle issues of motivation and fatigue in the managerial cadre and that top management is currently failing to do so.

The way the region functions today produces adequate performance. It is remarkable that one generation since the 1989 changes, there has been no significant collapse or breakdown of order



If CEE wants excellence, it needs to embrace and leverage complexity.

in the region. Yet if the society and economy of the region wishes to reach a level of excellence and potentially even a level of global leadership of ideas (if not practices), it needs to develop business and innovation strategies, management practices and public policy that can address, embrace, and leverage complexity.

business and innovation strategies, management practices and public policy that can address, embrace, and leverage complexity.





Mel Horwitch

Chapter 3.2.

# CRISIS, RENEWAL, AND LEAPFROG: CONTRIBUTIONS OF CONTEMPORARY INNOVATION AND BUSINESS STRATEGY IN EUROPE'S PERIPHERY

## CHAPTER IN BRIEF:

- ❏ Neglecting innovation and business strategy has become a weakness in the EU expansion.
- ❏ Developing high-value activities is imperative at national, regional, urban, and firm levels.
- ❏ New managerial thinking offers CEE a pathway out of its crisis, toward renewal and even leapfrog.

**T**he twin impact of the 2008 meltdown and the euro-debt turmoil that followed created a profound sense of disappointment throughout Europe. This upheaval is economic and financial in nature, but not entirely so because it also represents a crisis in confidence over the direction Europe chose for regaining its competitiveness.

European integration initially represented a visionary response to the continent's disastrous experience during the first half of the twentieth century and

the Cold War division of the next forty years. It is understandable that European integration would appeal to a continent ravished by two World Wars, division, genocide, and massive dislocation of peoples. With integration, Europe would assemble unity of purpose and convergence of interest so that it would never relive its deadly and stifling recent past.

Priorities for European integration soon expanded to include *economic competitiveness*, as Europe acquired scale and scope for competing and trading with giant rivals in North America and Asia in the last quarter of the twentieth century and first decade of the twenty-first century. From a competitiveness perspective, the European Union (EU) is now anchored on a long-held point of view that competitive success calls for scale, large and effective organizations, and a regulatory structure that would impose necessary order over its economic base with the resulting mega-economic powerhouse also supported by a continent-spanning common currency.

Behind all was a positive and supportive sense of optimism. Rivals and partners outside of Europe—such as America, Japan, and later China—generally favored an integrated Europe, seeing the formation of a large trading partner and common market as beneficial for their own export industries. The fall of communism in 1989, the reintegration of Germany and later the incorporation of formerly socialist bloc Central and Eastern European (CEE) countries into the EU mainstream provided further evidence of the attractiveness and inevitability of the European integration experiment.

Despite controversies over the nature and pace of European integration, especially in Norway, Denmark, and the UK, and close votes elsewhere in favor of the EU, the union's consolidation and momentum marched forward in the 1990s and into the twenty-first century. A reunified Germany became and remains EU's dominant economic force. In the 1990s, CEE's newly independent countries generally experienced high rates of outside investment and economic growth. All became part of the EU, although mostly remaining outside of the eurozone.

At the same time, the tide started to turn. An initial sign of trouble were roadblocks that prevented Turkey from entering the EU. Initially obstacles were on Europe's side, over concerns for protecting the continent from inundation of huge numbers of poor people and cheap goods from an unattractive developing part of the world. Later, of course, and vastly more significant, was a realization on the part of Turkey—a fast-growing nation in its own right—that its real priorities lay elsewhere. Does Turkey really need Europe as a partner for continued growth? Perhaps it is the other way around.

Meanwhile, the 2008 financial meltdown and euro-debt crisis two years later unhinged, stalled, and created further doubt over European integration. These events became catalysts for a profound rethinking about the European integration experiment—an endeavor that had hitherto possessed large and influential support.

Thus far, solutions offered to remedy the euro-debt crisis focus on fiscal policy and monetary reforms. The key policy tension revolves around who would suf-



fer and pay the most to stabilize Europe. This policy-balancing act involves a complex tradeoff for determining how much rich northern countries (particularly Germany) must contribute and how much fiscal austerity measures poorer, largely southern, countries must adopt.

Is this emphasis on fiscal and monetary policy sufficient and effective? Other possibly relevant factors are comparatively ignored. In addition to economic, macro-financial, and political perspectives, careful consideration of modern developments in innovation and business strategy fields is warranted as the latter set of ideas and practices may well provide new directions for renewal, at least for the European central and eastern periphery.

### **New Thinking and Practice from Strategy and Innovation**

Applying today's notions of innovation and business strategy—which throughout the world has resulted in successful new centers of prosperity and growth, via the rise of dynamic enterprises in new and established industries—to a re-examination of the EU's underpinnings and future may well result in useful lessons largely ignored until now. To do otherwise, thereby allowing the EU to run counter to such successful trends and actions, risks increasing the EU's lack of competitiveness and prospects for long-term decline.

While obviously difficult to summarize such a complex subject as identifying key characteristics of effective strategy in the early twenty-first century, the significant new features of modern innovation and business strategy today can be delineated using five major categories:

1. *Multiple Decision-Making Domains.* Domain here refers to the universe in which modern decision making occurs. The most fundamental difference in domain today is physical versus digital. Most of the core attributes of

decision-making structures—such as transaction costs, speed of information feedback, the notion of “distance,” information access, community membership—operate quite differently in these two domains. Moreover, newer domains overlay this fundamental divide, for example the rise of a pervasive mobile domain increasingly complements and exacerbates trends that started in the digital domain.<sup>1</sup>

2. *Shifting Sources of Value Creation, Knowledge, and Innovative Capabilities.*

The ultimate goal of modern enterprise is to create and deliver value, which is something deemed important by the user. The more sought after and unique a product or service is in the customer’s eyes, the greater its value as determined by the market. Over the past 300 years the focal point of value has moved from natural resources to agriculture to manufactured products to services to knowledge and innovation. So-called knowledge workers today earn approximately fifty times what their manufacturing counterparts earn.<sup>2</sup> Those engaged in leveraging knowledge through innovative capabilities create novel, productive, hard-to-imitate, and comparatively rare products and services, at least some of which are highly valued by users.

This search for innovative capabilities based on knowledge does not always require scale and massive resources. The state, large corporations, and startups are all essential for modern innovation to thrive; yet each type of innovation requires different kinds of skills, levels of resources, and organizations to achieve success.<sup>3</sup>

Public investment on a massive scale can be important for developing new technologies and industries. For example, New York State’s decade-long investment in nanotechnology is now starting to pay off with new multi-billion dollar fabrication plants in the state. In a different way, large firms can exploit their scale and scope through huge and far-flung corporate R&D facilities. Successful innovation also requires risk taking, creativity, and what Joseph Schumpeter called “creative destruction.” Hence, modern innovation involves entrepreneurship and startups. Of course, today’s innovation constellation manifests multiple and overlapping categories and blends of activities for new value creation.<sup>4</sup>

3. *Complementing Scale and Scope: Casting a Wider Net for New Ideas, Knowledge, and Key Resources.*

Scale and scope today are no longer sufficient for creating value. Another important feature characterizing value creation today is its escalating inclusiveness and openness in searching for new knowledge, resources, products, and services. While protecting intellectual property is important, uncovering new knowledge is imperative. More parties participate at the very beginning of the innovation process. This has led to what one scholar called the “democratization of innovation.”<sup>5</sup> Widespread collaboration for value creation is growing and accel-

erating because this approach has proven to be agile, flexible, and effective.<sup>6</sup> Examples include Wikipedia, crowdfunding mechanisms such as Kickstarter for startups, the mass collaboration “Jam” approach pioneered by IBM, and P&G’s Connect + Develop research approach.

4. *The New Globalization: The Uneven Spread of Regional (and Urban) Innovation Clusters*. Because of the rise of innovation clusters around the world,<sup>7</sup> the benefits of competitive success and the resulting pathway to continued and increasing prosperity are not distributed evenly, even in the same country. There are regional and urban winners and losers. A recent study of U.S. employment growth highlights this stark reality with, for example Northern California, Seattle, Boston, and Austin cast as winners while Cleveland, Toledo, and other comparatively declining manufacturing-based urban centers are portrayed as losers.<sup>8</sup>

Global developments reflect this same pattern of selective regional (and urban) agglomeration of competitive and value-creation power on a worldwide scale. The *Global Information Technology Report 2010–2011*, published by Insead and the World Economic Forum, ranked countries according to network readiness capabilities. Among the top twenty, Europe has eleven nations; Sweden (1), Switzerland (4), Finland (3), Denmark (7), Norway (9), the Netherlands (11), Germany (13), Luxembourg (14), the UK (15), Iceland (16), and France (20); the Asia-Pacific has seven countries Singapore (2), Taiwan (6), South Korea (10), Hong Kong (12), Australia (17), New Zealand (18) and Japan (19); and, North America is represented by the United States (5) and Canada (8). None of CEE or Balkan countries placed in the top twenty-five.

As noted above, there is an increasing acknowledgement of the influence of regional innovation clusters around the world. Even more startling is the growing attention paid to the powerful influential role of so-called global cities as hubs for attracting the talent, financial resources, and support services for nurturing modern value creation today.<sup>9</sup> Thus, as a useful unit of analysis, measuring and comparing national economies has diminished utility while regional and urban comparisons are growing in interest and value. There is a growing emphasis on regions, and especially on cities, as today’s competitive focal points.

Understanding and evaluating the role of cities modern competitiveness and value creation is a complex subject. The consulting firm PwC publishes a periodic *Cities of Opportunity* report. Cities across the globe are evaluated according to several broad criteria: intellectual capital and innovation, technology readiness, transportation and infrastructure, health, safety and security, sustainability, ease of doing business, cost, demographics and livability, and lifestyle assets. In 2011, New York edged out Toronto for the number one position. The top five were New York,

Toronto, San Francisco, Stockholm, and Sydney. No CEE city made the top twenty-six (Istanbul was 23 and Mumbai was 26). Other parties have recognized the potential of creating viable cities. As part of IBM's Smart Planet initiative, developing "smarter cities" represents a key line of business for IBM. The Intelligent Community Forum has held its annual Intelligent Community Summits for the past decade and a half, where it awards its annual Most Intelligent Community of the Year award. Without exception the winning cities represent North America, Western Europe, and the Asia-Pacific. No CEE city has ever placed in the Forum's top seven group.

5. *Agile and Flexible Reintegration: Networks and Ecosystems.* The importance of regions and cities for modern value creation is due not only to the fact that they host vibrant industries and lucrative firms, but also that these firms, regions, and cities gain strength through links and inter-connections that ultimately form powerful networks and ecosystems. The growing beneficial role of innovation and business ecosystems is increasingly acknowledged.<sup>10</sup> These vast constellations of firms, regions, and cities across the globe function as positive, reinforcing, and ever-more-powerful interactive ties, which then help members continue to improve and upgrade.

Ecosystems can grow within single economies; but their global power emerges when such networks cross national boundaries and become globe-spanning networks of regional ecosystems, identified as "Super Clusters of Innovation."<sup>11</sup> Ecosystems are designed, developed, and managed by forward-thinking firms such as GE, IBM, and Cisco, which even refer to their customers, suppliers and other third parties as ecosystem partners.

Ecosystem strategies are especially helpful in settings where rapid change can occur suddenly and where no single party controls all-important variables. In such situations ecosystem strategies are quite cost effective. They help firms avoid premature lock-ins while providing flexibility and continuous access to a wide range of ideas and market approaches. Ecosystems decision-making approaches are prominent where membership in platforms is essential, for example software, and where key players are powerful and disbursed, like smart grids.

### **Unexpected Divergence, Renewal, and Opportunity at the EU's Periphery**

The EU is experiencing an unexpected divergence. As Paul Marer points out in Chapter 2.2, there is now a wealthy, sustainable, and successfully innovative group of nations (and cities) in the west and north. They stand in contrast to countries in the south, representing part of the core of what was once the common market, and in the east and south, which contains a significant number of struggling member nations that are new to the EU and which are generally



saddled with huge debt. Consequently, European integration, a visionary undertaking that captured the imagination of many throughout the continent, has unfortunately now resulted in producing winners and losers. As George Soros recently observed,

The euro zone has become divided into creditors and debtors, with the creditors in charge of economic policy. There is a center, led by Germany, and a periphery, consisting of the heavily indebted countries.<sup>12</sup>

Mr. Soros and others have explained that much of this situation is due to long-run counter-productive monetary and fiscal policies and inadequate current solutions such as offering some aid while simultaneously pushing for stringent austerity measures on struggling debtor nations. There are also pleas for far-sighted leadership and statesmanship by all, most especially aimed at the richest economy in the EU—Germany.

New developments in innovation and business strategy may help in alleviating this situation. A first-cut examination yields a very different set of decision-making priorities than those underpinning the formation of the European Union in the 1990s and first decade of this century. Largely unnoticed in the



Absent in crafting of the EU are effective decision-making approaches.

crafting of the EU is a general absence of effective decision-making approaches that now thrive elsewhere in the world. This kind of thinking and action places less emphasis on traditional scale and on the institutionalization of enforce-

able regulations. Instead, new notions place more emphasis on flexibility, leveraging networks, and ecosystems, often on a global basis. This has resulted in the creation and strengthening of regional and urban hubs of innovation of all kinds, especially entrepreneurial and industrially innovative centers, and a capacity to seek resources and talent as needed, again increasingly on a global basis.

A relevant aspect of this new style of strategy and decision making is their appropriateness for smaller economies generally located in what were once assumed to be peripheries of economic progress. Countries like Israel, Singapore, Taiwan, Estonia, the Emirates and others, at times have all benefited by emphasizing smart infrastructure in cities, innovation, and participation in global ecosystems of value creation. Some of these countries exhibit an explicit sense of strategy and conscious choices of strategic directions. Furthermore, the struggling EU nations thus far do not as a rule host acknowledged influential hubs of new businesses and innovative strategic thinking.

Solutions anchored on newer and increasingly effective notions of innovation and business strategy should be considered by struggling economies in the EU, especially on its eastern periphery. Indeed, as shown elsewhere at national,

regional, urban, and firm levels, there is even the possibility of renewal and accelerated growth.

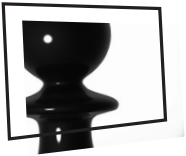
### Sketching the Agenda

Let me conclude by sketching the outlines of five main components for such renewal and accelerated growth:

1. Developing global-class hubs of innovation and business value creation—including IT infrastructure, a business-friendly environment, vibrant educational institutions, and a welcoming community—to act as a magnet for diverse talented people. In Budapest, for example, a group of entrepreneurial firms is rising and many support services have emerged, such as venture capitalists, industry associations, incubators, and a growing number of relevant events. But the scale is still small compared to known innovation clusters. The related worlds of venture and private equity are growing in CEE. Warsaw is the acknowledged venture capital (VC) and private equity (PE) leader. In Budapest, the Hungarian Venture Capital Association was recently founded to share knowledge and experience in order to accelerate VC and PE in Hungary. Furthermore, Budapest is home to startup firms that have expanded into global markets; for example, Prezi, Ustream, and LogMeIn. It was recently referred to as a “Startup City” by the UK’s leading entrepreneurship accelerator group.<sup>13</sup>
2. Promoting multiple kinds of innovation, supported by appropriate state policies and projects but also including revitalized large-scale corporate R&D and especially state-of-the-art entrepreneurship. The macro-policy environment should at least be neutral, if not friendly, toward innovation and entrepreneurship. Thus far, government policies stimulating innovation on the EU periphery are generally limited and uncoordinated. Reflecting a start in this direction Hungary’s Ministry of National Economy has established a National Innovation Office to encourage innovation.
3. Encouraging the formation of global scale, and often temporary, networks and ecosystems by looking outward, east as well as west, and through collaboration with a diverse set of partners.
4. Creating a climate and culture of inclusiveness and openness so that a greater range of talent and resources can be accessed.
5. Becoming a center of further creativity and a hub of innovation on innovation. This requires not only vibrant and successful large firms and entrepreneurial startups but also world class educational institutions in science, engineering, design, policy, and business. Although generally Central and

Eastern Europe are acknowledged to have superior technical universities, there is a dearth of world class business schools, and this absence limits the growth of prosperity and economic leadership in the region. Outstanding technology universities such as BME in Hungary, CVUT in the Czech Republic, or Warsaw University of Technology in Poland now have programs promoting entrepreneurship, startups, and technology transfer. But much more is needed.

A common argument is that it is too late for CEE to catch up. Other parts of the world not only possess growing economies but also the very knowledge clusters needed in CEE. But does such a predetermined and a despairing perspective represent the only future available? Are there other options based on smarts,



The current crisis  
can act as a catalyst  
for the periphery.

strategy, and human talent? Another vantage point can view the very crisis that now inflicts large swaths of the EU, including its central and eastern periphery, as providing at least the seeds for the opportunity of renewal and accelerated growth.

Thus, seen this way, the current crisis can act as a catalyst for the periphery not simply to recover and do better, but to emerge as a pacesetter in building a dynamic and more prosperous world.

## NOTES

<sup>1</sup> For digital domain's key characteristics, see Don Tapscott, David Ticoll, and Alex Lowy, *Digital Capital: Harnessing the Power of Business Webs* (HBS Press, 2000). For a more skeptical, incremental treatment of the digital domain, see Michael Porter, "Strategy and the Internet," *Harvard Business Review*, vol. 79 (2001), 3. For a rejoinder, see Don Tapscott, "Rethinking Strategy in a Networked World (or Why Michael Porter is Wrong About the Internet)," *Strategy + Business*, vol. 24 (2001), 7.

<sup>2</sup> Enrico Moretti, *The New Geography of Jobs* (Houghton Mifflin Harcourt, 2012).

<sup>3</sup> Mel Horwitch and C.K. Prahalad, "Managing Technological Innovation: Three Ideal Modes," *Sloan Management Review*, vol. 17 (1976), 1.

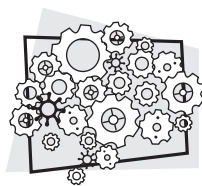
<sup>4</sup> Mel Horwitch and Edward Stohr, "Transforming Technology Management Education: Value Creation-Learning in the Early Twenty-First Century," *Journal of Engineering and Technology Management*, vol. 29 (2012).

<sup>5</sup> Eric Von Hippel, *Democratizing Innovation* (MIT Press, 2005).

<sup>6</sup> Don Tapscott and Anthony D. Williams, *Wikinomics: How Mass Collaboration Changes Everything* (Portfolio Trade, 2006).

<sup>7</sup> Michael Porter, "Clusters and the New Economics of Competition," *Harvard Business Review*, vol. 76 (1998), 11–12.

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- <sup>9</sup> Richard Florida, *The Rise of the Creative Class* (Basic Books, 2004); Edward Glaeser, *Triumph of the City* (Penguin Books, 2011).
- <sup>10</sup> Henry Chesbrough, *Open Innovation* (HBS Press, 2003); Marco Iansiti and Roy Levien, *The Keystone Advantage: What The New Dynamics of Business Ecosystems Mean for Strategy, Innovation, and Sustainability* (HBS Press, 2004); Dovev Lavie, "The Competitive Advantage of Interconnected Firms: An Extension of the Resource-Based View," *Academy of Management Review*, vol. 31 (2006), 3; Shaker A. Zahra and Satish Nambisan, "Entrepreneurship and Strategic Thinking in Business Ecosystems," *Business Horizons*, vol. 55 (2012).
- <sup>11</sup> Jerome S. Engle and Itxaso del-Palacio, "Global Clusters of Innovation: The Case of Israel and Silicon Valley," *California Management Review*, vol. 53 (2011), 2.
- <sup>12</sup> George Soros, *Crisis in Values*, Livemint, December 31, 2012, [www.livemint.com/Opinion/tdoeF5cGYwRN0WB06ymZhJ/Europes-crisis-of-values.html](http://www.livemint.com/Opinion/tdoeF5cGYwRN0WB06ymZhJ/Europes-crisis-of-values.html) (accessed 2 Jan. 2013).
- <sup>13</sup> Robin Marshall, "Innovation and Entrepreneurism: Hungary's Route Map to Success," *Voice* (AmCham of Hungary Magazine), September 2012, 17--19; "Startup City," *Entrepreneurship Country*, March 2013, 40--43.



Maciej Kisilowski

Chapter 3.3.

# REDESIGNING THE BUREAUCRATIC MIND: TOWARD FACT-BASED THINKING IN ECONOMIC REGULATION

## CHAPTER IN BRIEF:

- ❏ Formalistic bureaucratic thinking frequently leads to laws being applied in unreasonable ways.
- ❏ There are deep historic reasons why bureaucratic formalism is so strongly entrenched in the CEE region.
- ❏ Fact-based approaches to law are readily available; the business community has interest in advocating for them.

If you want a perfect horror story, take Joanna W.'s experience on Thursday night, October 26, 2012.<sup>1</sup> Only a few years earlier, she was running a small but profitable flower shop in the southwestern Polish city of Opole. Soon, the business faltered along with her marriage; abandoned by her husband, she closed the shop. Just before, she had made a fateful mistake. Instead of issuing a Value Added Tax (VAT) invoice to a client she had issued a normal receipt! Now, that was, in this particular situation, a criminal act under the Polish tax law, and the local branch of the Polish internal revenue agency fined her about 500 euros. By

the time the fine was imposed there was no shop and the single mother was now struggling to make ends meet. Worse yet, with more pressing issues at hand, she forgot to inform the agency about an address change. In the fall of 2012, the Opole's Municipal Court replaced the fine with a twenty-five-day jail term. The decision failed to reach Joanna at her new address.

The police arrived at about 9 pm, but Joanna was out buying groceries. They waited. When she came back, she tried to persuade them—for nearly an hour—not to arrest her until morning. Joanna did not have family in Opole and was concerned about who would take care of her two- and six-year-old children, both of whom had been kissed goodnight well before Joanna had left for groceries. But to no avail; the police woke up the children and, still in their pajamas, sent them to foster care and Joanna to jail. The later investigation by the Ministry of Interior concluded that all bureaucrats involved had acted properly and according to the law.

I suspect that a person doing business in Central and Eastern Europe (CEE) may not be that surprised by Joanna's story. Executives whom I teach or consult



Executives report  
ubiquity of sticking  
to the law, no matter  
how absurd.

almost unanimously confirm the peculiar ubiquity of this zealous bureaucratic formalism of sticking to the law, no matter how absurd the outcome may be. Typically, examples begin with minor nuisances. There is no written procedure

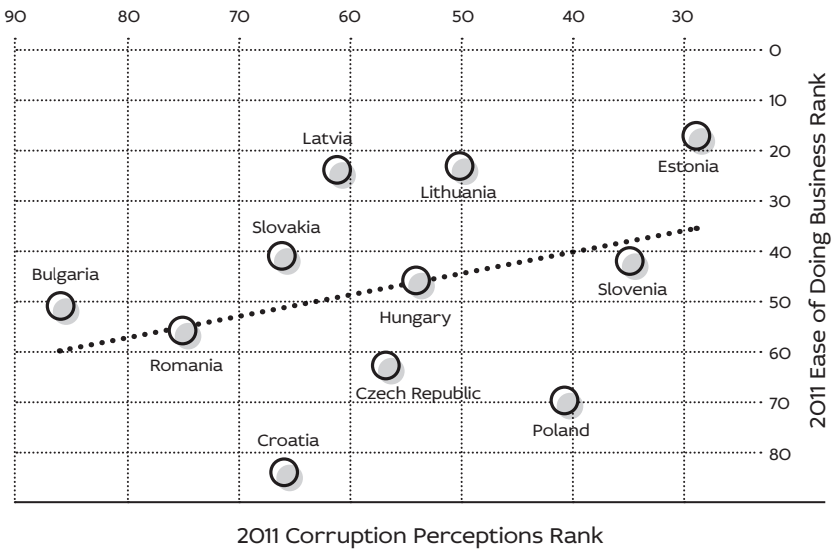
for you to see your passport photo after it is taken; thus you will not see it. Your neighbors systematically destroy the grass in front of your building because, after all, law-abiding municipal police officers will only fine those who have parked on grass. But then come more serious problems. A bureaucrat cannot inform you about the requirements of a permit application because the law provides a procedure only for informing you about the mistakes in an application already submitted. The law requires a foreigner to give a “permanent address in [their] country of citizenship,” even though they may not have lived there for a decade. Authorities insist on imposing certain taxes on deceased family members because the tax code does not explicitly provide an exemption for death in that particular section of the code. Sound familiar?

### Not Only Corruption

The conventional wisdom about this CEE genre of bureaucracy is that it is yet another strategy to facilitate corruption. According to this story, bureaucrats create formalist obstacles so that they can later “overcome” them, for a price. Clearly, interactions of this kind occur in the region. But think about Joanna W. The formalistic nastiness of every government agent involved in her case, from the tax authority imposing the criminal fine on a minor infraction, to the municipal court carelessly replacing the fine with a jail term, to the police that could not wait until the morning to make the arrest, surely cannot be explained by the desire to extract a kickback. Joanna was, after all, clearly unable to pay. Even

Figure 3.3.1.

Corruption and Red Tape in CEE



Source: Transparency International, Corruption Perceptions Index 2011 and World Bank, Doing Business 2011 (2012).

more important, any potential bribe would have to be “capped” at the amount of the fine itself, being thereby unattractive even to a low-paid bureaucrat.

For a bigger picture, consider Figure 3.3.1. On the horizontal axis, it shows how the EU11 countries fare on the world’s most well-regarded index of corruption, published annually by Transparency International. On the vertical axis, it illustrates the countries’ position in the World Bank’s Ease of Doing Business rank, a major global indicator of red tape. For simplicity, each country’s global position is presented according to the respective rankings (both rankings include the vast majority of countries worldwide). Furthermore, both rankings are presented starting at the bottom, with the most severe corruption and the most intense bureaucratic obstacles. The black dotted line represents the general trend; countries that are less corrupt seem to have less red tape. But this correlation is rather weak, specifically for countries under consideration. Even if corruption has something to do with the emergence and intensity of bureaucratic obstacles, there must be other factors that explain why stories like that of Joanna W.’s are such a constant feature of the CEE business life.

### The PLWT

My almost decade-long research of stories similar to that of Joanna W.’s makes me convinced that to really understand the senseless bureaucratic formal-

ism so widespread in the region, we need to bring the law into consideration. For in their essence, these horror stories are nothing but indications of how government agents approach the task of *interpreting* and *implementing* laws and regulations. No tax code, penal code, or criminal procedure code can specify exactly how a bureaucrat should behave in every conceivable situation. Legal rules are inherently imprecise and leave those entrusted with their implementation with the responsibility of interpretation. To help lawyers and other “heavy users” of legal rules navigate this blurry environment, legal elites in each society establish some tacit understandings on how written legal provisions should be understood and applied. I call it the Proper Legal Way of Thinking (PLWT).

It is not difficult to see how PLWT is formed. Prospective lawyers undergo years of highly standardized training consisting of university education, state exams, and apprenticeships under experienced practitioners. This lengthy process works like an efficient propaganda machine, shaping the minds of lawyers to take PLWT instinctively, as an obvious fact of life. Practicing lawyers, in their roles as attorneys, in-house counsels, prosecutors, judges, or law professors teaching at schools of public administration, interact with non-legally trained bureaucrats and thereby spread PLWT to those laypersons. In addition, as in most European countries, there is a large gap between the number of graduates of law faculties and the available jobs in legal practice. In effect, a number of law graduates, especially those less academically inclined, end up taking up jobs in not strictly legal professions, and as it turns out quite often, in public administration. Very quickly, the PLWT bacteria can infiltrate the bureaucratic mind.

Lawyers, and especially law professors, are quite aware of PLWT’s existence and its contagiousness. But they use a canny trick to shield their preferred version of PLWT from criticism. In particular, they put PLWT into a larger basket of what they call “legal culture.” That move gives them two things. First, thinking of PLWT as a type of culture makes any effort to evaluate the usefulness and sensibility of this culture suspicious. It is, after all, really in bad taste to be judgmental about other society’s cultures. In effect, PLWT becomes somewhat similar to an art form or a folk custom. If you start criticizing it, you can easily be portrayed as an arrogant cowboy who comes in, puts his legs on the table, and says “you need to do it our way.” You do not want to appear parochial, so when you hear “legal culture,” you intuitively conclude: “fine, it is different but it is an open-minded thing to accept such *cultural* differences.” The problem with this conclusion is that the analogy between PLWT and a piece of art is fundamentally flawed. At least in democratic societies, folk customs or artistic tastes are not imposed on all citizens with the full force of the entire state apparatus. “Correct” ways of legal interpretation, by contrast, can determine whether you end up in jail, and your kids in foster care, on a cold fall night. The ways bureaucrats and their lawyers interpret legal provisions impacts real lives and real businesses. It is absolutely fair game to subject these ways of thinking to a hard-nosed evaluation and criticism.





But there is also a second implicit argument underlying the strategy of framing PLWT as a type of culture. In a popular understanding, culture is generally something complex and elusive. When we use the term organizational culture, for instance, it is normally because we lack more concrete explanations for why people in an organization behave as they do. Thus, calling PLWT a “culture” sends a message that legal thinking is something so impenetrable that, even if you wanted to understand it and evaluate its impact on you and the country you live in, you may simply not be qualified to do it. Do not try to comprehend PLWT, leave it to lawyers. Yet historical and empirical evidence makes this complexity assertion highly questionable. Although details of how specific interpretational problems are solved do differ from country to country, the essential logic of the existing approaches to legal thinking seems to be rather simple. What is really important is how close a local PLWT approximates one of two model approaches to legal thinking that influence the legal practice pretty much around the world.

### Legal Positivism and Its Origins

The first, and by far the most dominant of these approaches, is often called *legal positivism*. Unfortunately, the name has nothing to do with positivistic lawyers’ positive disposition. The word positivism is not derived from positive but from *to posit* in a sense of “to put in place.” The idea is that the job of a lawyer is not to think about why the laws that have been put in place are what they are, but to simply take the words of the posited law, compare them with facts of a case at hand, and issue an objective technical conclusion. If gaps are found in the positive law, then a lawyer should apply one of generally recognized rules for filling them. These rules are the stuff first-year law students learn in positivistic law faculties.

Legal positivism has been so dominant in CEE that for many readers it may instinctively feel like an obvious approach to law. If you know anybody who stud-

ied law at a CEE university, you know that their grueling studies were essentially about memorizing hundreds upon hundreds of articles about various (“posited”) laws. But legal positivism is not the only possible approach to legal thinking. Indeed, rather than assuming legal positivism as a fact of life, we should ask: Why is the narrowly positivistic thinking so widespread in the legal life of CEE?

To find the answer we need to go as far back as the middle of the nineteenth century. In Western Europe, the Industrial Revolution brought an unquestioned triumph of the new urban elite over forces of the past. In Russia, by contrast, the weak bourgeoisie was unable to put any significant dent in the power of the traditional system. CEE was stuck in between. That was, not good enough for the German Kaiser Wilhelm I and his chancellor, Otto von Bismarck. They seized on a rather ingenious idea discussed for some time by German intellectuals: Why not to have a compromise between the old and the new? This is how it was supposed to work: The Kaiser would continue to control the policymaking process pretty much single-handedly, but his policies would no longer be imposed in an arbitrary way. Instead, his policies would have to take the form of properly enacted general legal rules that apply to all citizens equally. Moreover, individual citizens would gain the power to challenge in courts whether state bureaucrats properly implemented the laws enacted by the Kaiser. This two-prong legalistic approach would, in short, allow the Kaiser to keep his political power while granting citizens some important measures of stability and predictability.<sup>2</sup>

Central to the viability of this approach was the presence of a class of skilled lawyers who would patrol the behavior of state bureaucrats in their role as implementers of the Kaiser’s laws, but only based on “technical” grounds. And thus was created the CEE hue of legal positivism—the idea that lawyers should stay as far as possible from judging socio-economic merits of laws. That their social role is limited to interpreting the true meaning of words of which laws are comprised, and to cleaning up any logical inconsistencies and gaps within the system of those laws.

A particularly interesting aspect of this story is how this positivistic orthodoxy survived and thrived under communism, especially since communists were in fact quite vocal in their *opposition* to legal positivism. Lawyers were supposed to be active promoters of Marxism and not mere technicians. But this attitude changed as the early communist fervor morphed into the real-life socialism. Stubborn social opposition to the communist rule put the Party in a position strikingly similar to that of the German Kaiser a century earlier. Sharing political power was out of question, but giving citizens some sense of certainty and predictability through more consistent application of laws was once again a tempting compromise. The extra bonus was that by focusing on the socialist legality, the Party was able to better control the enormous apparatus of the communist state.

The final irony is that when communism fell in 1989, Western advisers who flooded the region knew very little about the entrenched positivism of the local legal profession. Many of these advisers acquired their knowledge of CEE from James Bond movies, with fur-coat clad, drunken communists driving around in

their Ladas and shooting people at random. Accordingly, from the very beginning, the thrust of the advisers' effort was to promote the establishment of the rule of law. This was a dream come true for local positivistic lawyers. For decades, their socialist legality had to compete with many other ideas for perfecting the "flaws and perversions" of the system. Now, the rule of law, interpreted not by the long-gone Western advisers, but by the good old local legal bureaucracy, became the major game in town. The fate of Joanna Ws of our region was set.

### Toward a Fact-Based Future?



We do not need to be prisoners of our history, or of our lawyers.

We do not need to be prisoners of our history or, for that matter, of our lawyers. Since the early twentieth century, a host of legal thinkers, particularly from the United States, have argued for a very different understanding of how lawyers should approach their jobs. This vision argues that law in a democracy

should be much less an art than a *tool*; it should be an instrument in the hands of an elected government to solve collective problems. Furthermore, with the rapid development of social sciences and the unprecedented sophistication of computerized hard sciences and engineering, the solutions to many of these collective problems become more a matter of evidence than of opinion. Consequences of various laws adopted by our governments can today be checked in the real world. Sophisticated modeling, such as the one mentioned by Michael LaBelle (see Chapter 2.5), can also predict how a law not yet enacted is likely to work. Instead of simply assuming the laws as being posited or imposed on us, we can fact-check their effectiveness.

These scientific fact-checks are obviously both complex and contentious; each model rests on assumptions and scientists can make mistakes. Further, multiple socially desirable goals can be in conflict with one another. For example, at the time of the introduction of the single European currency, the objective of strengthening the political unity of the continent seemed to be in tension with that of maintaining national fiscal sovereignty. Yet, as we can learn from Paul Marer (see Chapter 2.2), even in these ambiguous cases, anchoring our laws to the solid foundation of facts can be immensely helpful. If the predictable risks of the common currency had been properly addressed at the outset, the euro today could have advanced *both* the European integration and the national sovereignty much more effectively.

The approach to legal thinking that focuses mainly on the consequences, rather than on the letter or inner elegance, of laws is called *legal functionalism*. One obvious question that emerges is, of course, why do we even need lawyers under such an approach? Would it be better to simply replace lawyers with economists, sociologists, or engineers? I cannot fully address this challenge here, but let me just outline the contours of my response. In the functionalist world of evidence-driven laws we will need lawyers, just as we need doctors (and not only

molecular biologists) in a world of evidence-driven medicine, and management consultants (and not only theoretical economists and statisticians) in the world of evidence-driven business strategy. In all these cases, the theoretical knowledge coming from multiple academic disciplines must be *integrated* and *applied* by someone. Lawyers can play precisely this key role.

The vision of a lawyer as a middleman between the world of academic study of public policy and the practice of law making and its application is not a pipe dream. In the United States, top law schools have, over the past few decades, consistently been moving toward a more multidisciplinary curriculum, teaching students more about the goals and consequences of laws than about their “black letter.” In his recent book, Daniel Kahneman, a Nobel Prize winning psychologist, talked about a famous University of Chicago law professor, remarking that the professor in question

[i]s one of the foremost legal scholars in the United States, and shares with other leaders of his profession the attribute of intellectual fearlessness. He knows he can master any body of knowledge quickly and thoroughly, and he has mastered many.<sup>3</sup>

We are obviously a long way from our CEE lawyers becoming similarly voracious consumers of advanced economics, statistics, sociology, psychology, or environmental science. But I do believe that we can, and should, start moving in that direction.

### Implications for Managers

CEE managers have a crucial stake in redesigning the minds of our bureaucrats and policymakers along the functionalist lines. The formalist culture was perhaps adequate for conducting the task of copying voluminous laws of the European Union into EU11 domestic legal systems prior to their EU accession. But think about the ambitious agenda for boosting entrepreneurship and innovation in our region outlined by Mel Horwitch in the previous chapter. Implementing even small fragments of such a



Managers have a stake in redesigning bureaucrats' minds.

vision would require massive legal reforms in fields ranging from corporate and tax laws to the laws regulating science and education. The precise nature of these reforms, and even the very

identification of areas for the most urgent or low-cost improvement, could not be copied from the West, as the very purpose of the exercise would be to become smarter, leaner, and more flexible than the West. Governments in CEE would need to study actual needs of businesses and major roadblocks faced by entrepreneurs. Bureaucrats at all levels, including tax officials and judges, would then

need to apply the new laws in a more dynamic, flexible way. Put simply, the fact-based or functionalist culture would need to emerge.

To make this point more concrete, let us return to the Joanna W. case. The very law that started her horror story, establishing a criminal sanctions on minor invoicing mistakes, would have likely never been enacted had the social and economic benefits and costs of such a drastic punishment been evaluated. Even if it *had* passed the fact-checking phase, the law would have had to be accompanied by a statement outlining the objective of the penalty and bringing specific evidence for why the solution adopted was the most effective way of achieving the goal. The OECD now requires that its member-states produce such statements, but CEE governments, by and large, treat them as little more than window-dressing.<sup>4</sup>

A solid statement of reasons and objectives would have been particularly helpful for the municipal court hearing in the Joanna W. case. Knowledge about the intended function of the criminal penalty and about the ways in which it was supposed to operate would have helped the court to interpret and apply the law in a sensible fashion. Based on such a functionalist interpretation, the court would have likely concluded that jailing a single mother with a now-defunct flower shop hardly advanced the goals of the anti-invoice-fraud policy. And even if the court had reached the opposite conclusion, the evidence-based regulation on arrest procedures would have surely provided for a less socially disruptive ways of arresting a single mother of two then upending the fragile family on a cold night.

I cannot outline here a detailed strategy for how managers and entrepreneurs can pressure CEE politicians and bureaucrats to abandon their formalistic approach to making and applying laws. But I do hope that the very awareness of the available alternative to our traditional legal thinking—the awareness that I hope this chapter has provided—can be a useful first step on the path towards this much-needed intellectual change.

## NOTES

<sup>1</sup> All my facts come from the extensive press coverage of Joanna's story. See, e.g., Izabela Żbikowska, "Opolance Zabrano Dzieci za 2.000 zł Długów" [Woman from Opole had kids taken for the debt of 2,000 zloties], *Gazeta Wyborcza*, October 26, 2012; Izabela Żbikowska, "Aresztowanie Opolanki. Czy Sąd i Policja Mogły się Zachować Inaczej?" [A woman from Opole arrested. Could the court and the police behaved differently?], *Gazeta Wyborcza*, October 27, 2012.

<sup>2</sup> For a classic description of the "positivistic compromise" in the late nineteenth-century Germany, see Leonard Krieger, *The German Idea of Freedom: History of a Political Tradition* (Beacon Press, 1957).

<sup>3</sup> Daniel Kahneman, *Thinking, Fast and Slow* (Farrar, Straus and Giroux, 2011), 148.

<sup>4</sup> See, e.g., OECD, Recommendation of the Council on Regulatory Policy and Governance, Paris, 2012.





Davide Torsello

Chapter 3.4.

# THE NEW CIVIL SOCIETY: CORRUPTION AS DISCURSIVE EMPOWERMENT

## CHAPTER IN BRIEF:

- ❏ Emphasis on civil society can facilitate CEE's European integration more effectively than the traditional top-down approach.
- ❏ Research shows how CEE's civil society groups use corruption as a communication strategy to fight infrastructural projects they oppose.
- ❏ Actual corruption in state and local governments provides discursive power to anybody who focuses on this issue.

**T**he concept of *civil society* is one of the oldest and most contested in Western political and sociological thought. One academic definition defines civil society as a “category that both describes and envisages a complex of dynamic ensemble of legally protected nongovernmental institutions that tend to be non-violent, self-organizing, self-reflexive, and permanently in tension with each other and with the state institutions that frame, constrict and enable their activities.”<sup>1</sup> The complexity of the definition closely reflects the wide spectrum of social and political activities that it encompasses, as well as hardly classifiable domains and arenas of these activities. To cut through this complexity, we can point out that civil society movements are typically incorporated associations that operate as nonprofit organizations. Although these are usually referred to as nongovernmental organizations (NGOs), it would be naive to think that

these organizations function in isolation from for-profit businesses and governmental agencies. For the environmental NGOs that are the focus of this chapter, local governments are of particular importance. Typically, environmental NGOs depend on project funding, through local and trans-local bids.

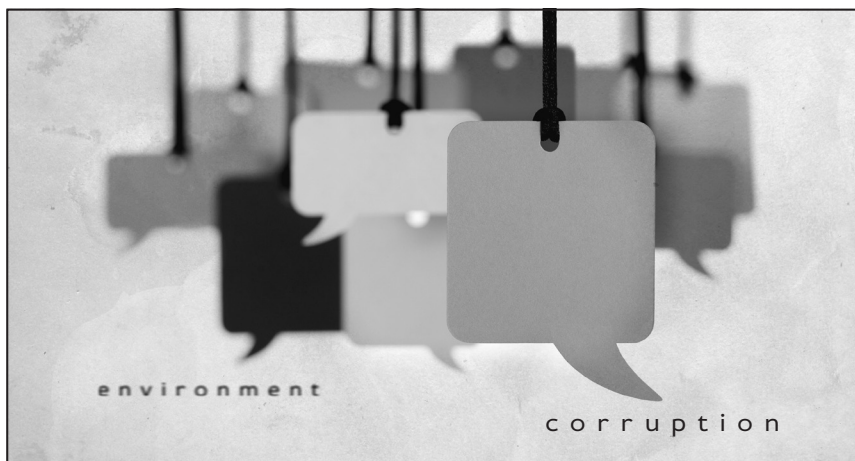
There are two conflicting and apparently irreconcilable views on the development of civic movements in Central and Eastern Europe (CEE). One indicates a generalized weakness of civil society as a common feature of the transition processes in the region.<sup>2</sup> The second relates to the actual dynamism, plasticity, and richness of the civil society organizations, although with some relevant differences between CEE and Western European countries after 1989.<sup>3</sup> These two positions are apparently irreconcilable because they actually tackle the same problem but under different premises. The first assumes that in order to study the level of civic engagement in CEE, it is necessary to espouse a comparative, often quantitative methodological perspective not only within this half of the continent, but more significantly, with the Western half. The second, taking a prevalently qualitative approach, investigates similarities and dissimilarities of the movements, organizations, and alike, which are considered as products of the transformation and the EU enlargement process.<sup>4</sup>

### **CEE's Environmental Activism and Bottlenecks of European Integration**

My own decade-long study of the development of CEE's civil society movements has often focused on one category of such groups: those that deal with environmental activism and advocacy. These movements, either local branches of global organizations, such as Friends of the Earth or CEE Bankwatch, or local associations based in small communities, have become increasingly politicized. Their new power stems from several tensions in the economic, social, and political spheres. These tensions emerge both from the ties of these movements with the social and ecological environments of the region in which they evolve, and from their interactions on the global arena of transnational institutions and other civic organizations. The first source of tension deals with the challenges facing national sovereignty (in policymaking and development planning) of states under the influences of neo-liberal capitalism and global governance.<sup>5</sup> The second concerns the tendency of the movements to seek more direct political intervention and, at the same time, the way in which they deal with decreasing mobilization from below. The third is the sharp difference between the Eastern and Western European concepts of mobilization, collective awareness, institutionalization, and political participation.

The ethnographic part of my research has focused on five case studies: the Považská Bystrica highway in Slovakia, Vienna-Brno highway, M0 Budapest ring road, TAV fast railway in the Susa Valley in Northwestern Italy, and illegal shipments of waste from Western to Eastern Europe. The projects are all potentially harmful to the environment, an aspect that contradicts the legal prescriptions under which they were planned and approved. They are examples of how





a well-connected and cooperative EU project can become stained by the emergence of a number of economic and political bottlenecks. These bottlenecks are not simply “unintended consequences” or effects of NIMBY (not in my backyard) protests, as some analysts have hastily declared, but rather they constitute the price that each member state, and within them each regional government, has to pay for the realization of the efficiently enlarged European community. The gap between East and West, manifested in these case studies, is increasingly evident in the ways in which infrastructure development projects are being planned, implemented, and managed.

### **Environmentalism and Corruption**

The differences between East and West are not only in the cultural perspectives of the assessment of environmental hazards. They can be interpreted from two other perspectives: the top-down and the bottom-up approach. In the traditional top-down approach, EU enlargement policies and EU-funded development projects, although built on the common notion of a well-connected Europe, still work along very different institutional and economic tracks. When local governmental institutions are plagued by widespread corruption, clientelism, a high prevalence of personalized and informal strategies, and the intermingling of public and private interests, political bottlenecks can significantly increase the costs of EU enlargement projects. Similarly, in the economic sphere, the corporate business investments in CEE have exerted a strong influence on the outcomes of environmental protests, not only because of the pervasive link between business and local politics, but also because of the development rhetoric.

The analysis I present in my recent book<sup>6</sup> offers a different, bottom-up approach. Civil society is the product of local, national, and transnational forms of environmental activism. Departing from the historical conditions that

have rendered problematic the analytical use of the notion of civil society in widely varying contexts from Italy to CEE, this research traces a significant link between EU enlargement projects and the strengthening of civic participation from the bottom. Here, civil society is the response to the blindness of the resource allocation process within structural development projects. These projects fail to anticipate problems that arise from their implementation at local levels, including the issues of environmental sustainability, transparency of governments, and business integrity.

The bottom-up approach has further explored the previously overlooked interaction between CEE's environmental activism and the impact of corruption in EU-funded development projects. My empirical research demonstrates that the protection of the environment constitutes the ideological basis on which civil society is built at local and regional levels. However, in the long-term of all the case studies under my consideration, corruption is the issue on which protests gain strength when the environmental problem has lost its power of attracting mobilization from below. Corruption becomes a crucial factor when considering the configuration of power emerging from the interplay of local, national, and transnational (EU) stakeholders. It is this corruption that increasingly alienates citizens from political participation, decision making, and even resistance.

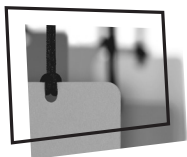
### **Corruption as Discursive Power**

The novelty of new CEE's environmentalism lies in the ways in which policies are negotiated or opposed by the environmental protest. The emergence of corruption scandals in transportation development projects (frequently in the construction business sector), the lack of transparency in bidding and project allocations, and the resulting "low" quality of governance, are all factors that strongly influence the perception of the positive and negative effects of development projects, especially considering that these factors are exacerbated by the existing political and economic conditions. As soon as these projects manifest their devastating potential, not only on an environmental but also on a political, economic, and moral scale, civic movements have tried to inform the local public.

The hazards of environmental damage constitute what anthropologists call *public discourses*, that is, communication strategies developed in public by civil society organizations that do not last long, as they tend, in the long run, to lose appeal. At this point, the awareness of corruption scandals pushed forward by abundant media coverage became a strategy for local activists who could stir citizens' interest in ecological advocacy and civic movements. Whether the excessive politicization of these movements has transformed them from genuine bottom-up forms of civil society into political stakeholders with their own intents and aims remains an issue that is difficult to analyze.

Another issue revealed by my ethnographic study of corruption is the impact that the increasing prevalence of corrupt practices in the public sphere has on

the legitimacy and power of public and even private institutions involved.<sup>7</sup> The crucial issue is that corruption in state and local governments has provided legit-



References to corruption become a weapon to stir citizens' attention.

imacy and relevance to environmentalism, bringing it closer to the people through the use of a common language. Abundant references to corruption scandals become a weapon in the hands of civil society organizations that use

news (alleged or confirmed) of non-transparent bids, public money diverted into private profit, or even money derived from taxation, which is converted into profits of companies close to local politicians to stir citizens' attention. This creates an effect that in anthropology has been defined as "corruption talk," that is the overt and frequent use of corruption scandals in public discourses, first by NGOs and then by citizens themselves. In other words, widespread corruption in state and local governments has provided legitimacy and relevance—*discursive power*—to the rhetoric used by environmentalism. Emphasizing the corrupt nature of their adversaries helps activists to come closer to the people through the use of a common language.

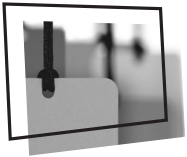
This legitimizing effect of the corruption talk is unique in CEE cases, and partially to Italy, for three reasons. First, the new civil society has assumed, as expected, different tones in these countries compared to their Western European counterparts due to the conditions under which civil society emerged. During the last years of socialism they were born as anti-political movements, but not definitively separated from the state: a symbiotic relationship in which they have often continued to exist. Second, corruption is present and has been widely exposed through the media to the public. This infers that when generalized corruption talk becomes a social norm, it can be used as a powerful discursive tool to communicate the harm that may be caused by these environmentally, politically, and socially intrusive projects. In this case, this form of discursive empowerment becomes effective in extending the lifespan of environmental movements, as well as giving regular citizens concrete examples of how these major construction and development projects can impact not only the natural environment, but also the political and social environments in which they live. Civic organizations have become increasingly politicized and have assumed a strategic role in the decision-making process. Corruption has very much become an impetus for the attempt to bridge formal and informal strategies, since discourses on corruption are mostly built informally by civic organizations.

Overall, corruption is not only about bad practices; as has been demonstrated by this chapter, it is also a tool of communication for civil society organizations—the tool that not only supports the credibility of these organization, but also gives activists and local followers some sense of participation in local politics.

## Same Civil Society?

At the end, I need to return to the issue with which I begun—the difficulties and controversies that surround the notion of the civil society made the very use of the idea as a tool for understanding reality somewhat problematic. Social scientists—and among them notably anthropologists—are, in particular, reluctant and uneasy to parallel civil society in Western Europe with the social contexts of CEE.<sup>8</sup> What can be inferred from my proposed bottom-up analysis and the cases I studied, is that civil society has been strengthened by the EU enlargement process. Yet, this is a different kind of civil society compared to the one described by classical thinkers in their discussions on civil society, such as Antonio Gramsci, Alexis de Tocqueville, or G.W.F. Hegel.<sup>9</sup> There are many differences between the environments under which civil societies operate, including the changing role of the state, the influence of the socialist experience, the global conditions of governance, the influence of neo-liberalism, the changing perceptions of social justice, the evolving legitimacy ascribed to these organizations, and the popularization of issues related to corruption.

Nonetheless, it makes sense to address civil society in the peculiar conditions of the post-socialist experience and EU enlargement process. This notion is



“Corruption talk”  
gives people some  
sense of political  
participation.

undermined or exalted (depending on various factors) by reference to corruption cases as a strategic ways to maintain the credibility of these movements. Hence, through the analytical use of the civil society concept, it is possible to

test the validity of the idea that changing historical (and geographical) conditions permanently affect the relationship between state, economy, and society.

## NOTES

- <sup>1</sup> John Keane, *Civil Society: Old Images, New Visions* (Stanford University Press, 1998), 6.
- <sup>2</sup> Marc Morjé Howard, *The Weakness of Civil Society in Post-Communist Europe* (Cambridge University Press 2003); Gabriel Badescu, Paul E. Sum, and Eric M. Uslaner, “Civil Society and Democratic Values in Romania and Moldova,” *East European Politics and Societies*, vol. 18 (2004).
- <sup>3</sup> Helmut K. Anheier, Eckhard Priller, and Annette Zimmer, “Civil Society in Transition: the East German Sector after Unification,” *East European Politics and Society*, vol. 15, no. 1 (2000); Barbara A. Cellarius and Caedmon Staddon, “Environmental Non-governmental Organizations, Civil Society and Democratization in Bulgaria,” *Eastern European Politics and Societies*, vol. 16 (2002), 1.
- <sup>4</sup> Davide Torsello, “Trust, Kinship and Civil Society in a Slovakian Village,” *Sociologia—Slovak Review of Sociology*, vol. 40, no. 6 (2004), 514–529.

- <sup>5</sup> Italo Pardo and Guiliana B. Prato, "Introduction: Disconnected Governance and the Crisis of Legitimacy," in *Citizenship and the Legitimacy of Governance. Anthropology in the Mediterranean Region*, edited by Italo Pardo and Guiliana B. Prato (Ashgate, 2010).
- <sup>6</sup> Davide Torsello, *The New Environmentalism? Civil Society and Corruption in the Enlarged EU* (Ashgate, 2012).
- <sup>7</sup> Davide Torsello, "The Ethnographic Study of Corruption: Themes in Political Anthropology," QOG Institute, University of Gothenburg, Working Papers (2011).
- <sup>8</sup> John L. Comaroff and Jean Comaroff, *Civil Society and the Political Imagination in Africa: Critical Perspectives* (University of Chicago Press, 1999); Ernest Gellner, *The Conditions of Liberty: Civil Society and its Rivals* (Penguin Press, 1994); Elizabeth Dunn and Chris M. Hann, *Civil Society. Challenging Western Models* (Routledge, 1996).
- <sup>9</sup> See, for instance, John Keane, *Civil Society: Old Images, New Visions* (Stanford University Press, 1998).





Zoltan Buzady

Chapter 3.5.

# BREAKING WITH THE LEADERSHIP FANTASY: ADOPTING A MORE REALISTIC MODEL OF DRIVE AND MOTIVATION

## CHAPTER IN BRIEF:

- ❏ CEE's businesses are often led by fast trackers—top executives who rapidly advanced in the early 1990s.
- ❏ Today's middle managers need to learn how to manage their fast-tracker bosses, with all their failings.
- ❏ The Absorption-based Model of Leadership is a flexible tool to optimize one's managerial competencies at every level.

**T**he preceding three chapters have all outlined the nature of a gap that seems to run right across Europe, dividing the 2004 big bang EU expansion states from the Western part. This is a gap created through differences in thinking about competitiveness and innovation, differences in thinking about laws and regulations appropriate for the real needs of individuals, business and society, and differences in the type of the public discourse the every democratic society must carry to make collective choices. Parallel to these three, a similar discrepancy can also be found in the context of thinking about busi-

ness leadership. This chapter outlines the relevant historical context and provides more evidence about this leadership gap. It then explores in greater detail my own leadership model that may be helpful to develop more insightful, flexible, and sophisticated managers and leaders of the future.

Despite its common historic roots, the division of Europe during the Cold War induced divergent developments not only in the economic and political systems, but also through the proliferation of rather different leadership styles in East and West. In oversimplified terms that means that the Western management



CEE's managers  
depend on access  
to centralized power—  
or “politicking.”

systems are characterized by the objective of optimizing performance, as well as safe-guarding and building on positive effects of groups and teams. By contrast, the success of managers in Central and Eastern Europe (CEE)

fundamentally depends on their ability to access and influence the “central power” that distributes scarce resources as a mechanism for survival (i.e., politicking). In the context of managing people at work, the traditional command-and-control, top-down, management-by-telling style became paramount, and the word *leadership* per se became a politically contaminated, negative concept.

After the political, social, and economic changes in our region, the most successful new managers were the most agile, often not older than twenty, or those in their mid-careers capitalizing on the emerging management buyout opportunities in the privatization bonanza. Retrospectively, we can see that both groups were able to ride the wave of the old style subordinate environment by redirecting their managerial actions toward the performance expectations of new startups and Western investors. They worked extremely hard and long hours, and by successfully pushing through the new ways of doing business they were able to deliver sensational results to their new but geographically distant CEOs and company owners. They made an excellent “external” career, a questionable “internal” career, and often paid high cost in their private lives.

Starting in 2000, many of these fast trackers of the 1990s established themselves as top managers, bosses, or company owners. But I have noticed an interesting trend when discussing real leadership challenges with my MBA students who are often from the “next” generation that entered high-end corporate jobs after the fast trackers. My MBAs look for ways to best influence their own bosses and CEOs who, in my students’ judgment, have become ineffective and inaccessible. These fast trackers are stuck with outdated business techniques that limit company growth by ignoring new possibilities and with old favoritisms and preferences for old comrades.

Very little has been published on the topic of managing one’s boss in this specific CEE context. I believe there are two reasons for that. First, Western management has been understood to be directed downward or laterally, but not upward. Second, over the decades, organizations in market economies have



developed systems to select the most competent individuals to become their leaders. These Western leaders, unlike many CEE fast trackers, are capable of sustaining business performance and nurturing effective teams.

Based on experiences gained from teaching leadership and general management for more than a decade in CEE, I have found that many of my MBAs intuitively believe that they have to replicate or at least to mimic this Western conception of leadership. It is a widely held belief among these motivated, hard-working, and talented mid-level managers, that a leader should be full of motivation and that the responsibility to motivate followers lies exclusively on them. I think and teach that in reality better work attitude and higher level work performance depend less on the leaders' personal motivational powers, and more on the motivating work environment that surrounds them. I like to challenge the widespread conviction that the primary tools to effective increase of motivational levels are bonuses and other top-down motivational incentives. In fact, we have to accept that, taken out of the leadership context, these rewards are not very useful motivational tools at all. In my MBA classes, it takes quite some time and work to develop trust sufficient for participants to concede that balanced human relations matter more than their original ideas of motivational tools and incentives. However, they have little exposure to leaders and role models with this mentality and cannot imagine how they could possibly operate this more sophisticated, yet systematic and practical leadership approach.

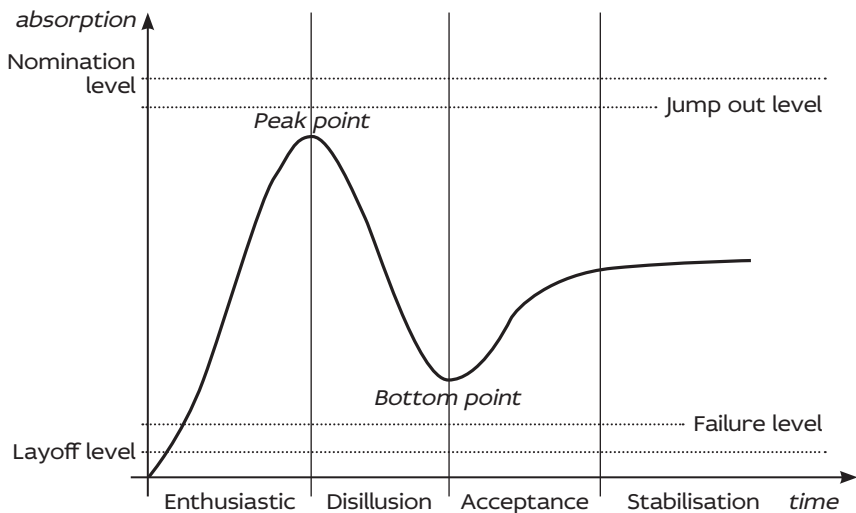
### **Absorption-based Model of Leadership**

If a leader diligently observes his direct subordinates and team members, he will be able to measure their performance, engagement, and commitment to their jobs. If these observations are done regularly and along pre-determined criteria, then the leader will notice that his measurements will show a wave-like curve. This curve, which we call the absorption-based curve<sup>1</sup> (see Figure 3.5.1), represents the personal motivational cycle of employees. The performance of all subordinates will show characteristics, consisting of four distinct phases: enthusiasm, disillusion, acceptance, and stabilization. Managers and subordinates can influence the personal curve by setting promotion/layoff and personal performance levels (see Figure 3.5.1). Naturally, these levels are strongly influenced by external factors such as business climate, scarcity of key talents, relative level of employee turnover, and so on.

But the process of leading people is not deterministic, it rather invites managers to exercise their managerial skills in judging which of the many tools they can apply, when, and in which combination (see Figure 3.5.2). It is important for the leader to be aware that if he makes appropriate leadership interventions and steps in at the right situation (the inflection points of the curve), he will not only improve the personal relationship with his subordinate, but also become a more efficient leader. My own Absorption-based Model of Leadership (AMoL) helps to understand when to increase and decrease the work-

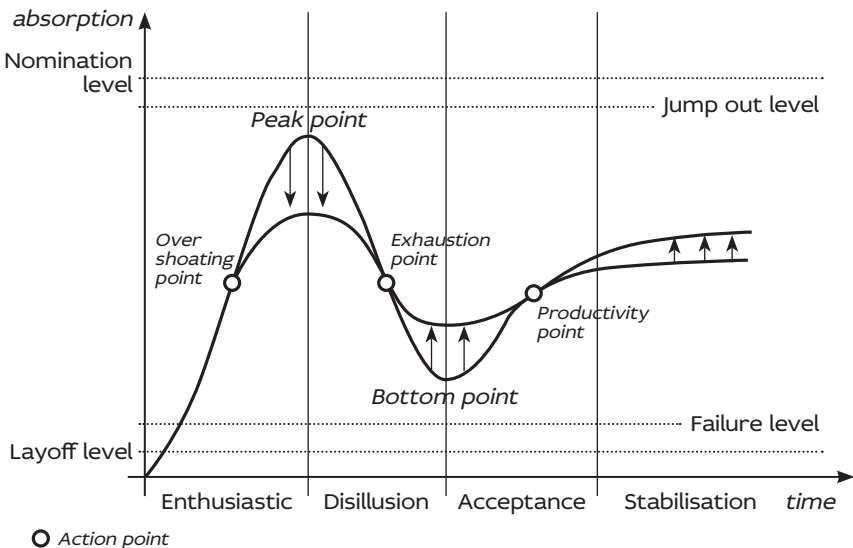
# Figure 3.5.1.

Absorption-based Model of Leadership: Fundamentals



# Figure 3.5.2.

Critical Leadership Intervention Points



Source: Zoltan Buzady and Achilles Georgiu, „Riding the Waves of the Motivation Cycle—The Absorption-Model of Leadership,” OD Practitioner Journal of Organization Development Network, Vol. 43 No. 1, at 35-42 (2011).

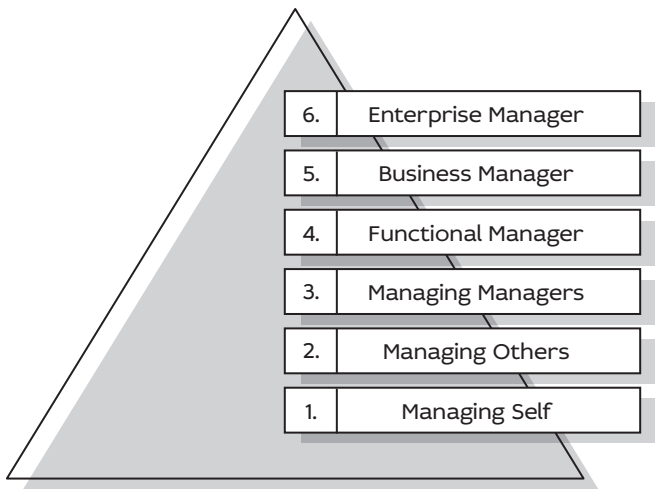
load of subordinates, how to handle people in the various phases of their motivational cycle, when to promote them and when not to, and how individual motivational phases affect the overall team performance. This new leadership approach can be represented with a simple, wave-like, but dynamic curve. With the help of this approach we can visualize not only the individual absorption levels and motivational cycles of individual employees, but also gain insights into the configuration of the various group members and follow the cycle of what is often referred to as an “effective team.”

The typical intervention process of AMoL is the following: the manager follows the subordinate’s absorption curve, modifies it in order to optimize it, and then uses simple and customizable management tools as leadership interventions. But the relevance of the AMoL is widespread; its core idea is that performance follows a wave-like curve can also be used when guiding departments and their corresponding functionality, local subsidiaries, associated business units, and whole enterprises on a global scale. In the following section we will see how the AMoL framework can serve managers at different leadership levels.

**Changing Focus on Leadership Transitions**

Drawing distinctions between hierarchical levels is one of the fundamental attributes of organizational science. Further, the notion that those levels pose distinct managerial and leadership challenges is a fundamental tenet of modern management thinking. Many models differ in the way in which they describe the actual characteristics and hierarchical structure of managerial levels.

**Figure 3.5.3.**  
Six Levels in the Leadership Pipeline



The stages of the leadership transition model, sometimes called the leadership pipeline (see Figure 3.5.3), help organizations nurture their own leaders internally at all levels: from entry level to the senior management. It can also provide



Rather than repeat the past, individuals must develop for leadership at the next level.

guidance for managers in CEE by identifying their future leadership trajectory, addressing their competences, and providing a blueprint to plan their development. Further, it can help them plan how to successfully lead as they ascend

the leadership ladder and to grasp what type of mentoring to seek from seniors. Staying stuck without appropriate improvements in their skills and leadership focus, even while progressing formally upward, may lead to stagnation on a personal or organizational level, inefficiency and in extreme cases, failure. The personal challenge therefore is clear; individuals must develop new mindsets and new skills that prepare them for leadership at the next level, rather than returning to familiar routines used at previous or current managerial positions. This will result in increased flexibility and effectiveness.

*Level 1: Managing Self.* The bottommost level is about moving from the past of college studies and career/personal dreams to the here and now of job realities. It is about exploring one's channels of motivation and ascertaining the outer layers of critical success factors, strengths, and weaknesses, and potential early signs of a preferred leadership style.

*Level 2: Managing Others.* The second level is about the transition from working independently to managing others and efficient delegation. The new working style has to be about getting work done through others. This requires significant change in attitude; to be successful, one has to share knowledge and information, offer exchanges, and be aware of the others' needs while providing direction. This can only be achieved through dialogue characterized by exchanging personal views, setting goals and expectations, mutually defining criteria and key performance indicators, making judgments and dynamically evaluating the relationship between leader and follower, all of which are central concepts of the AMoL. New leaders should enhance their communications skills, both written and oral, and learn how to work effectively in teams. The AMoL accommodates team members' individual needs and encourages regular feedback. It prompts a leader to establish a list of concrete targets for his subordinates. During our MBA, group managers soon realize that they cannot possibly fulfill all program requirements alone and need to delegate to other team members. The most successful students learn at this stage how to ask for feedback from peers and open themselves up for 360-degree evaluations.

*Level 3: Managing Managers.* The entrance to this stage is characterized by the sudden increase of hands-on professionals that a person is responsible for. At Level 3, a manager's critical success factor is to know how to hold his subordinates accountable. Thus, they need to be able to manage both "the carrot" at

an advanced level that is to be capable to help subordinates through coaching and mentoring; and “the stick” in a sophisticated way. This is particularly challenging because at Level 2, a new manager should know how to motivate people to cooperate with each other to achieve a goal; at Level 3, by contrast, they must know and have the tools necessary to build effective and lasting teams. This function requires insights into psychodynamics at a group level and the courage to engage in this complex web of relationships.

These Level 3 managers also need to know how to use “the stick”: how to allocate resources to subordinates. An MBA student learns that these resources are staff, support functions, technology and, often perceived as the most important, money. Therefore, they learn how to budget effectively, to identify inefficient team members and teams, and to channel additional funds and resources to improve the overall performance. To be a good manager at Level 3, one needs to have internal fortitude to address unpopular issues and the capability to effectively withhold resources and opportunities from their own management team when the leadership situation demands it for a higher cause.

*Level 4: Managing a Function.* In larger organizations, middle managers often report to the country manager or general manager and at the same time they are responsible for functional areas or units, such as finance, production, human resources, and business development. According to theories that describe stages of career development, this step requires advanced personal maturity and the ability to connect with other departments and to act as a liaison. The AMoL approach has many similarities with the maturity curve propagated by The Gartner Group, a technology research consultancy. They argue that any piece of technology, IT solution, or technical approach has different use and dissemination phases among its users. A manager adopting the AMoL sees the relative contribution (absorption) of each subordinate, workgroup, or management team evolving over time while remaining a vital element of the wider unit and maintaining its input into the functioning of the organization. With this insight, a manager will be better able to understand that the relative importance and contribution of his own functional area to the organization is dynamic, potentially critical and core, routine, marginal, or even counterproductive.

A Level 4 manager thinks strategically and manages with having the entire department within his awareness. He must know how to think long-term while planning for the medium term, turning the organization's long-term goals into elements of his functional strategy. This is a key element of most core MBA subjects: how to achieve overall mission and vision of a firm while maintaining the functional areas (marketing, ITM, HRM, etc.) in focus. This process is not only an internal activity, but it also requires managers at Level 4 to be actively engage in external loops. Henry Mintzberg described this characteristic among the ten roles of a manager. The manager scans the external environment to spot new solutions and approaches, which he then incorporates into his own organization, a process Mel Horwitch described in Chapter 3.2 as the “democratization of innovation.”

The importance of managers to be good listeners may have become common knowledge and it remains particularly important for Level 4 functional managers. They must focus on exercising their active listening skills and master body language while digesting and utilizing sophisticated theories about personality profiles. I have noticed that our MBAs now increasingly request school support for self-discovery opportunities and that more mature students particularly cherish engaging in more philosophical discussions about how to understand and better influence different personality types.

*Level 5: Managing a Business.* This transition, another radical change, requires the professional to handle high complexity situations without receiving guidance from above. They have to manage and coordinate not just one discipline, but the whole range of a firm's business functions. To be successful, a business manager must be able to identify, formulate, and protect the core values of his business unit (including new value concepts such as "network readiness," as outlined by Mel Horwitch) and to develop a constant stream of offering (products or services) to leverage the organizations core competencies. In 1911, the Harvard Business School introduced an integrative course in management, Business Policy, aimed at providing general management capabilities. In 2012, this is still at the core of any MBA program, although usually referred to as Strategic Management or Key Dimension of Strategy. Managers learn that they need to anticipate the implications of future growth in all areas of the organization through an integrated approach. Understanding all business functions and their interrelationships are the basics. They must further know how to sequence changes, to reconfigure organizational units to better achieve core processes and to improve the organizational decision-making process to capitalize on new growth opportunities. Without these insights, business managers can make costly strategic mistakes that end in tragic corporate endings, demonstrated by a vast collection of MBA case studies.

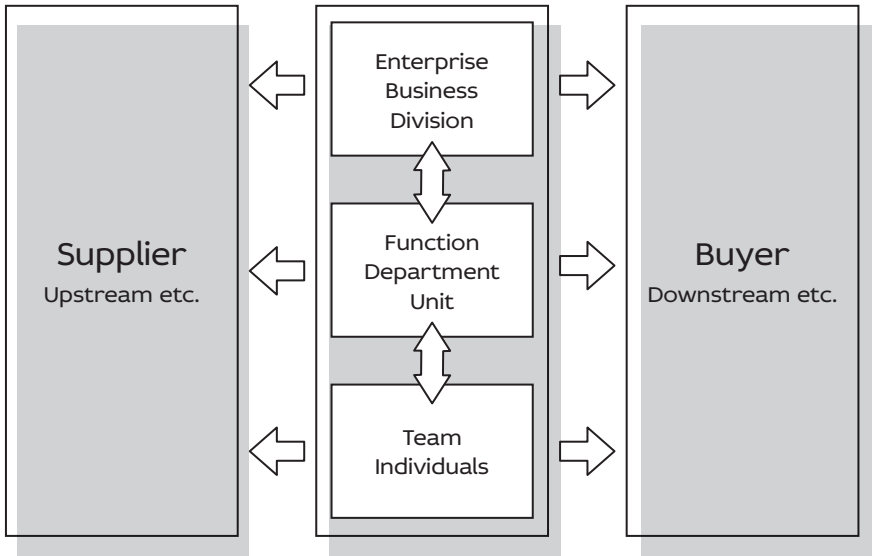
On a personal level, business managers need excellent skills in time management because they need to know almost instinctively what are the key projects and key people to address at any specific time. They are able to constantly and successfully address tasks that are both important and urgent.

*Level 6: Managing an Enterprise.* This top management layer, often overlapping with the previous category, is especially distinct in large, complex, international corporations working with a diversity of products, technologies, or markets. The CEO, at the top of the organizational career ladder, holds the most visible position. As such, he strongly influences how his firm is viewed by both people within and outside of his organization. Reaching this level requires a shift in personal values and perceptions. Level 5 management requires a manager to be able to put his professional past aside (remember, typically he has risen to Level 5 from having managed a particular functional group) and adopt a completely new leadership reality. At Level 6 the nature of management becomes different again; it becomes the art of people management in its pur-

est form. Similar to the powerful networks and ecosystems of successful cities described by Horwitch (see Chapter 3.2), an enterprise manager has to handle a multitude of stakeholder groups, most notably the board, the owners and their representatives, analysts, internal and external partners, direct subordinates and a seemingly endless list of local decision makers. A successful enterprise manager is capable of working effectively with all these different persons and parties. Many leadership scholars suggest that this becomes only possible once an individual has managed to develop the requisite humility and internal power to lead with an authentic vision attractive enough to be shared by the stakeholders. The process for this leadership is not a stoic, remote one, but rather rooted in quick decision and action, which itself is based on the leader’s mastery of all appropriate decision-making techniques.

Ultimately, the CEO has to take a calculated risk of permanent decision making in complicated and highly unpredictable problem environments, typically in opposition to some key stakeholders whom he needs to balance. To be able to stand these financial, personal, and moral pressures he needs decisiveness, character, integrity, and inner strength. The AMoL integrates the notion that enterprises need to be managed in such way that all internal and external stakeholders’ valid interests are taken into account in a balanced way (see Figure 3.5.4).

**Figure 3.5.4.**  
Relevant Management Levels and Congruent Stakeholders



Former MBA students, who by now have advanced several years through the leadership pipeline, mention that the intensity of our academic programs and fast pace of individual and group learning activities pushed them to their personal limits. At this point, they can experience that they cannot solely adequately resolve situations and problems with their existing technical skills. Instead, they begin to trust their own inner strength and character attributes to strive and open themselves up for value-based leadership approaches. I think that, in the future, harnessing Level 6 managers will require even more individual and coached small-group reflection opportunities.

### Closing the Leadership Gap

I have started my chapter by questioning the notion that bonuses and commanding more and more resources are the key motivators and measures of managerial success. Great management and true leadership are far more complex and subtle than that. To master the constant managerial and leadership challenges, a practical model, flexible to evolving business complexities during one's career advances, is needed.

We have seen the essential characteristics of the AMoL—a leadership approach and managerial toolbox I have been researching and expanding over the years. As our MBA students become familiar with these concepts, they have the opportunity to adopt them, better master their own management challenges, and customize them to their management level. The AMoL is versatile enough to be modified and expanded to the varying needs of managers throughout their career stages and progression process through the organizational leadership pipeline anywhere in the world. In CEE specifically, the AMoL can contribute to closing the current leadership deficit in the region's management practices.

### NOTES

- <sup>1</sup> Zoltan Buzady and Achilles Georgiu, "Riding the Waves of the Motivation Cycle: The Absorption-Model of Leadership," *OD Practitioner Journal of Organization Development Network*, vol. 43, no. 1 (2011), 35–42.





Jay Fogelman

Chapter 3.6.

# ATTACK OF THE CYBORGS: A NOTE ON THE LIMITS OF ONE “NEW WAY OF THINKING”

## CHAPTER IN BRIEF:

- ❏ Traditional economic theory has been under attack from the new, popular discipline of behavioral economics.
- ❏ Behavior economics itself suffers from a number of conceptual and practical limitations.
- ❏ When applying “new ways of thinking” to CEE, we should be cautious not to follow intellectual fads.

**O**n the afternoon of 6 May 2010, the Dow Jones Industrial average, the principal measurement of performance of the New York Stock Exchange (NYSE), dropped suddenly and quickly by over 800 points. During the remainder of the trading session much, but not all of the loss was recovered. Analysts and pundits were at a loss to explain this panic, for a classic panic it was. Nothing in the financial or political news was found to explain it.

It was a rogue trader, some said. No, it was a simple error of a trader accidentally entering a grossly overstated number of shares in a single trade. No, it was a computer glitch.

The last explanation is perhaps the most interesting. But what do the pundits mean by a computer glitch? Typically, this expression refers to a programming bug, an error in the logic of a computer program that which results in an unex-

pected, unintended, erroneous output. Nevertheless, this glitch and the offending program were never isolated.

## Evolving Thinking

For at least a generation, the predominant theory about financial markets used in academic journals and taught at MBA programs was that these markets were rational, that is that pricing in such markets reflected rational expectations based on available information.<sup>1</sup> In the 1990s, however, a new approach emerged. According to this view, actors in financial markets (and in markets in general) digress predictably from rational decision making. Numerous empirical studies provided the basis for identifying a number of so-called biases, or patterns of irrational trading which provided predictability and explicability for anomalies in market behavior that did not conform to the thesis of rationality. This new approach became known as *behavioral finance*, and more generally, *behavioral economics*.

Suddenly, intricate models of rational market actors gave way to explanations based on what we might as well call “quirks of human nature.” To give an example from a related field, it has been observed that in a significant number of cases, negotiators will settle for a worse deal than they have already made with another counterpart, because of an agreement bias. Translated into a psychological explanation, this means that many negotiators feel that they have failed in a negotiation if they do not reach an agreement, even if that agreement provides less value than another agreement they already have in hand.

The essence of the theoretical contribution of behavioral finance is neatly encapsulated in the title of Dan Ariely’s book—*Predictably Irrational*.<sup>2</sup> Purely analytical models of pricing and information, then, must give way to more complex models of statistically predictable irrationality based on the empirical studies that identify and quantify biases. This approach seems reasonable. Although its research strategy is more complex and challenging than that of its predecessor, it seems to promise the power to explain anomalies that would be inexplicable under the theory of rational markets. Over the past two decades, behavioral economists have introduced an impressive assemblage of potential biases. In addition to the agreement bias, we have confirmation bias, self-serving bias, hindsight bias, availability heuristics, hyperbolic discounting bias, to name but a few.

## New Thinking, Good and Not So Good

An important premise of at least some of the chapters in this part of the book



Some “new” ways of thinking discussed by my co-authors are not always really new.

is that business, political, and social leaders in Central and Eastern Europe (CEE) would do well if they replace their faulty intellectual approaches with new and better ones. Zoltan Buzady puts it most clearly in the previous

chapter, when he talks about an intellectual “gap that seems to run right across

Europe, dividing the 2004 big bang EU expansion states from the Western part.” But the “new” ways of thinking that my co-authors envision are not always really new; surprisingly often, they come straight from intellectual agendas of elite American universities. Kisilowski, for instance, seems to want CEE to adopt a legal culture of Yale Law School. Likewise, we can easily imagine Horwitch’s quarrel with the rigidity of the EU economic governance being brought up at a faculty seminar at Harvard Business School.

To be sure, my co-authors may be perfectly right about the fruitfulness of the specific intellectual approaches they promote, but behavioral economics represents a perfect example of precisely this kind of a new and exciting paradigm. Consequently, some serious challenges for behavioral finance which I propose to discuss, may be taken as a cautionary tale. Something that is wildly popular in American academic circles does not necessarily bring meaningful improvements (or even deeper understanding) to the real life business practices—in CEE, or in New York City.

### **First Problem: Description, Explanation, Prediction**

Let us start then with the very basic problem; with a story told by behavioral finance. As mentioned above, it does a neat job of naming various patterns of possibly irrational behavior. But does calling a quirk “an agreement bias” really explain it? It certainly seems to be a good description of the market behavior we observe. Nevertheless, description and explanation are two different things. In some way, behavioral economists’ quest for mere naming various biases resemble Moliere’s ironic account of a scientist who explained opium’s power to put people to sleep by appealing to its “dormitive virtue.”

Consider that “John broke his leg while walking on the sidewalk” may be a good description of what happened. But if we cared about John’s accident, would we be satisfied if an academic told us that the man suffered from a probabilistic phenomenon known as pedestrian bone fracture? It surely adds little to our understanding of what has happened. By contrast, saying “John broke his leg falling on the sidewalk, because he slipped on the ice” adds some meaningful explanation to the description.

Admittedly, the distinction between description and explanation is fuzzy as different people can have a different definition of what counts as satisfactorily explaining of an event. So why should we care? Most important, going from description to explanation is the first step on the path to the ultimate goal of predicting future events. Anybody active on a financial market knows that the ability to predict future trends on the market is priceless. Keep in mind that all investment is a gamble. It is risk taking based on expectations about the future. Consequently, wielding an accurate predictive power about future behavior of actors in financial markets may be a source of much-desired advantage.

Does getting to an effective explanation automatically guarantee obtaining such predictive power? In the physical sciences, the answer tends to be yes: we often

have a strict symmetry between explanation and prediction. When an astronomer predicts the phases of the moon, the basis of her prediction—an appeal to physical law and observed phenomena—itself constitutes an explanation. It seems, that we cannot adopt this principal of symmetry as a hard and fast rule: most people regard the theory of evolution as powerfully explanatory, but weak in prediction.

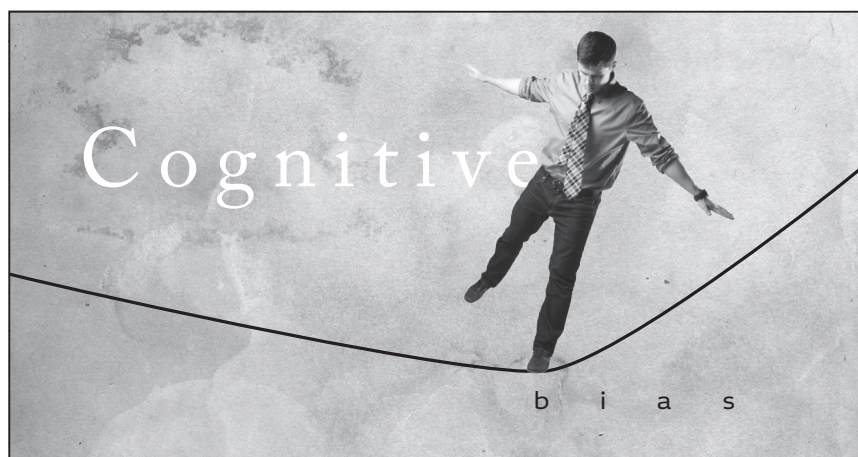
The bottom line is that behavioral finance would be much more interesting and far richer in practical application when, in addition to describing interesting events, it would be able to explain them, and to reliably predict the occurrence of similar events in the future. By analogy, consider the financial crisis: few predicted it, particularly in its scope and long-term effects, but there has been no shortage of post facto explanations. Every explanation assumes a theoretical framework, and every theoretical framework lays claim to some degree of confirmation by virtue of its ability to explain. When a prediction is fulfilled, the degree of confirmation seems stronger.

### **Second Problem: Whose Quirks?**

The limitations of behavioral finance may pale by comparison with another challenge: the decreasing role of humans in generating trade on the global financial market. Consider that today over 70 percent of the transactions executed on the NYSE originate not from the hands of human traders, but from so-called algorithmic traders (ATs—computers that monitor the flow of trading on the exchange and react much more quickly than humans ever could). Some—indeed, most of these programs are designed for high-frequency trading (HFT), completing transactions in milliseconds.<sup>3</sup> These platforms trade so quickly, and are so dependent on speed for competitive advantage, that their companies have sometimes tried to place them as physically close as possible to the clearing centers, leveraging shorter communication paths for advantages measured in microseconds. These proprietary, highly competitive programs and the overall effect on trading are the reasons that Wall Street firms have migrated away from hiring MBAs and experts in finance and have, instead, sought out experts in computer science and engineering, so-called quants.

Here is one potential response to my argument about the waning role of humans in the operation of the financial markets: “Surely these electronic trades are just initiated by human brokers and carried out at lightning speed with the help of computers.” Yet a moment’s reflection will reveal that this account cannot be right. A device that executes thousands of trades in seconds cannot be human-driven, at least not in the sense that each of its transactions is separately initiated by a reflective and reactive human being. Humans don’t make and implement thousands of high-level decisions in seconds.

Time aside, there is another, more important reason to regard these programs as true originators of these transactions. Many of these ATs are programmed as artificial neural networks (ANNs), so named because they are designed on the model of biological nervous systems. What is special about them, in very simple terms, is



that they are programmed to act—that is to compose and execute a trade—only when certain thresholds of input are met or exceeded. Although a human trader sets these thresholds initially, the fluctuations in market activity can cause the programs to modify these thresholds. In short, the ATs dynamically reprogram themselves. This means that neither the human trader nor even the programmer knows what criteria the AT is using to make trades at any given moment. If it was just a question of a decision to trade or not to trade, we might regard the AT's action as a mere tool of the human trader's decision; but when the thresholds have been changed, the AT is using a decision criterion that is unknown to the human trader.

So, whose biases are we investigating now? With thousands of trades issued by computers within seconds, we are facing not just an augmentation or acceleration of old-fashioned trading activity, but a problem in complexity. We have entered the realm of chaos theory, a realm where prediction is not possible. And as I mentioned earlier, it is the predictive power that gives any theory most of its practical utility.

### Way Out of the Chaos?

Even without the complication of a cyborgcrowd, the domain of our massive financial markets descends into a morass of complexity. The promise of the recently developed theory of complexity is that, from the apparent chaos, there will emerge a recognizable and, predictable order. The approach of behavioral finance is to seek this order in the recognized and soon-to-be-charted biases of the cognitive, individual, human animal. Is such a hope justified?

Consider a smaller, but instructive example: In April 2011, the Internet book-seller amazon.com offered a paperback copy of *The Making of a Fly*, a study of the genetics of the fruit fly, for \$23,698,655.93 (plus \$3.99 shipping).<sup>4</sup> This book, while undoubtedly of considerable scientific merit, is not the Gutenberg Bible. How did it become so precious? In fact, the pricing on Amazon is based

on the interaction of Amazon's pricing algorithm (implemented in a computer program) with the similar, competing algorithms of many other booksellers. In the accelerating circle dance among these computers, something went awry. It would probably be fruitless to try to identify a programming error—a glitch—in one of these programs. It was their competitive race that produced what we modestly characterize as an anomaly.

Yes, there is a well-known bias in human psychology that can lead to what is known as the “winner's curse,” a tendency to make unreasonable decisions for the sheer satisfaction of being the last man standing. We see it at auctions all the time. It is a common prelude to buyer's remorse. Nevertheless, it is hard to believe that even the most biased of human sellers would seriously offer this book at such a price. If behavioral economists were merely predicting the outcome of a race to maximized yield among humans, they might have seen the price going up to perhaps a couple of hundred dollars. What is the rule of thumb they could invoke to predict the result of the interacting computer tournament?

Human investors are quick to recognize such obvious mistakes after the fact but, because many different complex algorithms are interacting in the marketplace, we have no model to predict or prevent them. This is the challenge to the promising field of behavioral finance: to cross the threshold of description to real explanation with the helpful, in fact indispensable, support of predictive power.

It is a principle of behavioral finance that individuals and markets display the results of irrational behavior, but the unreasonableness of humans and that of cyborgcrowds seem to differ not only in degree, but also in kind, and these are the markets that demand our study now, and will do so even more in the future.

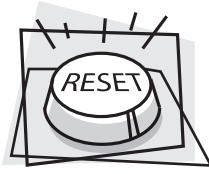
## NOTES

<sup>1</sup> See, for example, Eugene F. Fama, “Market Efficiency, Long-Term Returns, and Behavioral Finance,” *Journal of Financial Economics*, vol. 49 (1998).

<sup>2</sup> Dan Ariely, *Predictably Irrational: The Hidden Forces that Shape Our Decisions* (Harper-Collins, 2008).

<sup>3</sup> See, for example, Irene Aldridge, *High-Frequency Trading: A Practical Guide to Algorithmic Strategies and Trading Systems* (Wiley, 2009).

<sup>4</sup> The story is well-chronicled at [www.michael-eisen.org/blog/?p=358](http://www.michael-eisen.org/blog/?p=358) (accessed 27 Jan. 2013).



Chapter 3.7.

## RETHINKING CEE: AUTHORS' DISCUSSION OF PART III

### CHAPTER IN BRIEF:

- ❏ New business thinking should help managers navigate the current environment, but also challenge structural inefficiencies underlying this environment.
- ❏ New thinking is needed at many levels: regional, national, and organizational.
- ❏ Oftentimes, new business thinking will have to originate in CEE and not be automatically replicated from the West.

**M**aciej Kisilowski: Thank you for participating in our final discussion. This third part of the book is somewhat different from the previous two but also particularly important. Because academics and teachers in Central and Eastern Europe (CEE) often need to find a balance between two distinct objectives. On the one hand, we search for and teach short-term prescriptions on how to survive in a highly imperfect business environment that managers must face every day. On the other hand, we always harbor the ambition to become change agents and to help managers whom we teach to become such agents. How do you improve the crooked world in which you operate? How much do we simply help to navigate among the sharks and how much do we encourage CEE business leaders to become shark hunters? And if we pursue this latter objective, introducing new, innovative ways of thinking would seem to be one of the first steps to take.



## Periphery and Breakthrough

**Paul Marer:** This tension between “world as it is” versus “world as it should be” is visible from the very first chapter of Part III. If I understand it correctly, Mel argues (in Chapter 3.2) for a rather fundamental redesign of the managerial and political attitudes of the periphery members as well as those at the core of the EU. The periphery members can and should use the new and tried methods of developing innovation clusters and smart business strategies to catch up and perhaps even leapfrog the more developed core of the EU. Mel’s related argument is that the EU’s institutions are too inflexible and the EU’s policy frameworks insufficiently suitable to help promote innovation clusters and supporting business strategies for that purpose.

Attempts of the periphery countries to catch up with the economically more advanced Western European countries have been repeated and generally unsuccessful for two centuries, as has been chronicled in dozens of books and hundreds of articles. Furthermore, because even today the medium-term growth projections for the periphery countries are modest, Mel is correct that it is time for the periphery to seek new sources of convergence, along with new EU policy frameworks and institutions to assist them.

Realizing the space limitations of a chapter, Mel’s advice would have been even more useful with hints about how the sweeping changes he postulates should begin to be implemented. Which agency should do what to promote the implementation of his suggestions? How should managers change their approach and attitudes to leverage the advantages of being located in the periphery?

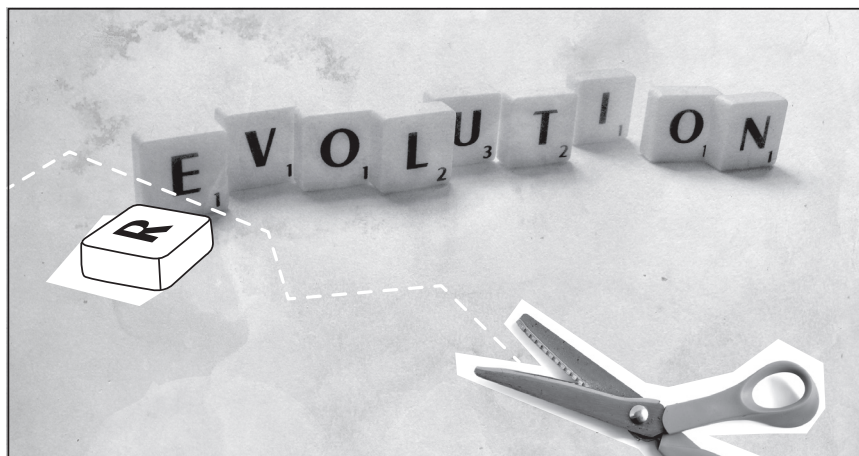
**Noémi Alexa:** I would also be concerned about the feasibility of implementing your proposal, Mel. To establish the kind of macro-policy environment you envision, we would need major structural changes in the use and redistribution of state resources in CEE. And if our recent history can teach us anything, it is that such changes only happen in this region under pressure from the EU. Without such pressure, the innovation-related initiatives will remain window dressing.

**Maria Findrik:** Unfortunately, it is characteristic of the entire EU that it could not break through and become the innovation-driven economy its leaders envisioned in the Lisbon Agenda adopted in 2000. If we do not want to lose the values and the attractiveness of Europe, we have to rethink how to redefine and restructure the EU, how to allocate and manage resources—but jointly! CEE’s progress relies on a strong and efficient EU.

**Maciej Kisilowski:** I agree with Maria. Whatever Central Europe has accomplished after 1989—in fact, whatever Europe has accomplished since World War II—has happened only because of European integration. Perhaps we are too quick to take peace and stability in this continent for granted.

**Yusaf Akbar:** Let me supplement Maciej’s comments here. We must be extraordinarily careful in recognizing that the EU project has two ongoing fea-





tures. First, it is a work-in-progress and therefore to pass judgment on it at any moment in time tends to skew the analysis. If we were to think of Europe in 1957 at the birth of the project and compare it today, we have made extraordinary progress even if we may express frustration at its imperfect progress: “Two steps forward, one step back” as one of my professors of EU integration would say. To think that we now have twenty-eight member states, more than a dozen of which come from CEE is a remarkable achievement and should not be underestimated. Second, the political component of preventing war on the continent is of paramount importance and the EU stands out as an institution that can provide a buffer against its widespread return. Croatia, a country torn by civil war less than a generation ago, is now an EU member state. Remarkable. We should therefore understand that economic decisions and the integration process are embedded in a much broader project of political and social transformation.

**György Bögél:** I would also like to add that the EU is really a mixture of many states in different phases of development. The center-periphery phenomenon is a general problem in many countries, regions, and states. Innovation cycles have their winners and losers. Detroit, the capital of car production and automotive innovation, declared bankruptcy in 2013. In general, innovation indicators of the U.S. states are highly differentiated, just like in the EU. Innovation may be concentrated in some towns, regional or industry clusters. Regional or national indicators may hide internal differences.

**Maria Findrik:** The main reasons for which the CEE countries cannot realistically leapfrog have little to do with the EU. For one thing, there is no viable model of transition to advanced, innovation-based economy. For another, there is a heavy burden of expensive welfare system inherited from socialism. Third, many CEE countries were also seriously hit by the crisis. I agree, however, that

the most attractive and reasonable ways to close the gap should be innovation and entrepreneurship rooted in competitive, high-level education systems.

**Mel Horwitch:** For me, it is clear that CEE fundamentally must find ways to escape from that part of its past and heritage holding it back and must discover portals into a prosperous and meaningful future. I think the notion of “periphery” in this regard should not be shortchanged. We have already witnessed how in a knowledge economy small nations far away geographically can prosper. Sin-



There is no viable model of transition to advanced, innovation-based economy.

gapore and Israel come to mind. Moreover, relative smallness is not a disadvantage anymore. Many of the most competitive and innovative nations of the world are small. There is also lurking here a quite interesting related question

regarding how much of a prisoner we are, as human and institutional actors, in determining our future. Are we simply rats in a maze adapting to powerful economic, historical, and cultural forces? My notion is that nations and their citizens must increasingly act with a sense of strategy in facing reality.

### Discourse and Managerial Power

**Caterina Sganga:** “Sense of strategy in facing reality” sounds, to me, like a good middle ground between the “world as it is” and “world as it should be.” And, I must say, I think this balance is missing in Maciej’s piece (Chapter 3.3). To be sure, I may even agree with the general point about the superiority of fact-based policymaking. But the first thing a reader will ask is: How can I overcome such a problem here and now? I cannot go to the regulator, ask her to go back in time, change the curriculum in law schools, and relearn how to think about economic regulation. Managers should think that the revolution may start from them, rather than wait for it to fall from the sky. You talk a lot about communication, which is a two-way street. Perhaps managers need to acquire that particular legal astuteness that would help them use law in a functional manner. If they cannot change lawyers’ minds, they should understand how to convey effectively their arguments, pushing the lawyer to read the law in a less formalistic and more business-oriented way.

**Peter Hardi:** Also, there is a question if functionalism is really better? After all, what business expects from a regulatory framework flexibility, stability, and predictability. So perhaps functionalism is more flexible, but then if predictability suffers, especially in a place like CEE, I’m not sure businesses would like that deal.

**Maciej Kisilowski:** That is a very common reaction, Peter. On the one hand, people often say “of course functionalism sounds more reasonable, you should think about consequences of legal regulations.” On the other hand, if we give people this ability to interpret law with its consequences in mind, then we will lose a lot of predictability. In fact, my research shows that the formalistic approach is more unpredictable, after all. Think about it: In the past, you had a

civil code for 100 years, nothing changes. Then the formalist culture of interpretation of this code does bring you stability. But today the world changes so fast that every year you get new directives from the EU. And in such a world, it's the functionalist view that gives you more stability. Because it forces every actor—from the cabinet that introduced the bill to the parliament, to bureaucrats that implement a given regulation—to spell out specific reasons why a given regulation or a given interpretation of a new regulation makes sense.

**Peter Hardi:** So are you saying that the functionalist discourse forces politicians to be more predictable?

**Maciej Kisilowski:** Exactly.

**Peter Hardi:** Well, whether you are right or not, Davide shows us clearly (in Chapter 3.4) that discourse, in general, is a powerful thing that managers should really appreciate. I think what spices things up here is that the example of this discursive power at hand is the talk about corruption. Unlike most studies of the region, you do not seem to be saying, Davide, that corruption is a problem. Talking about corruption is simply a vehicle, a weapon to be used to further one's political position. Corruption in this case is not something that is good or bad, but it is something to be used as part of your arsenal, to get something accomplished. It exists in the world and you have to use it or take advantage of it. It is a very scientific view of corruption, rather than value laden.

**Yusaf Akbar:** I agree that it is really interesting. That's why it is important to have anthropologists in a business school.

**Davide Torsello:** It's true that corruption is mostly a vehicle in the cases I'm discussing. But there is also something to learn about corruption per se: If you are a manager, there are different forces at stake when it comes to corruption. It is not just between business and government; there are different layers, there are civic organizations there that are very powerful and that are using the kind of tools detailed in my paper.

**Caterina Sganga:** Davide's contribution can be nicely linked to Yusaf and Vukan's piece (Chapter 1.6). Because why is corruption such an effective discursive power? Perhaps because so many Central Europeans assume that, in their countries, things routinely get done in a non-transparent and pre-arranged way, or what Yusaf and Vukan call "grid." No wonder, then, that in high-grid countries people see corruption everywhere; and thereby arguments that emphasize real or made-up incidences of corruption are rhetorically effective. The macro and the micro are coming together to the same conclusion.

### Old Bosses, New Challenges

**Maciej Kisilowski:** It's good, Caterina, that you are bringing the micro-macro distinction to our discussion. Because one interesting thing about Part III is that it deals with thinking at so many levels. Mel talks about thinking in Europe and Zoltan (in Chapter 3.5) talks about organizations, but the root causes of some key intellectual challenges at hand seem to be strikingly similar.

**Zoltan Buzady:** The micro-macro links and parallels are very noticeable. In my chapter, I speculate that the peculiarities of our innovation policies or lawmaking processes have very similar roots to the specificities of CEE leadership needs. A very rapid transition, when people (the fast trackers) were suddenly presented with enormous managerial or entrepreneurial opportunities. And they got a sense that the success is no longer centrally distributed by the state but that power really comes from investors and Western companies. At the same time, they did not know anything but the old system of command and control. These people are now at the top of their organizations; they are owners or CEOs. And my MBA students constantly tell me: “what you teach is fine, but tell us how can I teach our stubborn, successful, rich owner that he should behave the way you tell us to do!”

**Maciej Kisilowski:** Let’s be blunt: the fast trackers were just lucky. In 1990–1991, you had, in consulting firms, partners with no managerial education. And the problem is that they were very young; thus they will be around for another twenty years. And people below them have to proceed via a regular route: go for an MBA, climb the ladder.

**Paul Marer:** You have used this wonderful phrase, Zoltan: “managing the boss.” I was yearning for some more practical advice on how do you do that. Clearly it is culture-specific how the bosses act and how the subordinates act.

**Zoltan Buzady:** You should start by realizing that our teaching cannot come only from the West. Because this Western thinking assumes that the market has



Our teaching cannot come only from the West.

selected leaders who are successful in delivering but also in creating healthy organizational systems. But that is, unfortunately, not the case. It is a little bit like Jay’s critique of behavioral economics (Chapter 3.6)—there is this

new, sexy current in the Western management thinking, but does it work in practice?

**Tibor Vörös:** Well, in fact, Jay’s point is that this Western management thinking may be quite useless not only when applied to CEE but also in the West. And I think that challenges of managing your boss is not a CEE-specific problem either. At one point I was involved with a German SME, where the original founder was still in charge. And it was this owner who often actually stood in the way of progress.

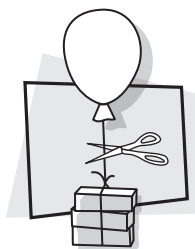
### Managerial Takeaways

**Peter Hardi:** Just to build on that. In my field of business integrity, we teach that ethics and integrity of a business depends mostly on the top. If you have a leader with some kind of ethical standards, these standards will trickle down but not the other way around. And because of this, in integrity studies, we face a very similar problem to one analyzed by Zoltan. We are stuck with leaders who have not had a chance to develop strong standards of ethics or integrity. But I

would not give up on these bosses. Perhaps, a school like ours should focus more on helping these top-level fast trackers to catch up. What we try to do in the Center for Integrity in Business and Government is to reach the fast trackers by emphasizing pragmatic benefits of integrity. In this case, integrity is no longer an ethical concept but a tool that can help the leader bring together necessary skills and build on and work within those skills. Perhaps the same can be done in leadership.

**Zoltan Buzady:** Maybe what I need to teach—both to our Generation-Y MBAs and to top-level fast trackers in our executive programs—is not traditional change management, but a course that may be called Creative Hierarchies. Or we can just be patient and wait another ten-to-fifteen years until our MBAs reach top echelons of their organizations. In any case, I find it amazing how many lessons from this book can be applied in our teaching and consulting interactions with CEE managers, at all levels. Actually, as I understand, Mel and Maciej are writing the concluding chapter focused precisely on such lessons that CEE managers can draw from this volume. It will be interesting to see with what they come up.





Mel Horwitch *and* Maciej Kisilowski

CONCLUSION:

# JOINING THE TWENTY-FIRST CENTURY AND THE NEED FOR CREATIVE PROFESSIONALISM

## CHAPTER IN BRIEF:

- ▣ CEE needs to become competitive, and that means embracing managerial professionalism and entrepreneurship.
- ▣ CEE managers must be realistic in assessing business opportunities, taking into account both market fundamentals and the business setting.
- ▣ CEE managers would benefit from adhering to high professional standards in their organizations—above and beyond the regional average.
- ▣ CEE managers should look for opportunities beyond the borders of their small home markets.
- ▣ CEE managers should be agents of systemic economic and social change whenever possible.

**T**here is a surprising and perplexing level of agreement among the diverse group of contributors to this volume. All are deeply committed to bringing best managerial practices to Central and Eastern Europe (CEE); yet at the same time they convey an underlying sense of puzzlement and even dis-

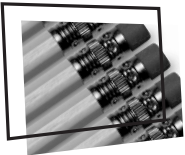
appointment. Despite an initial exuberance and a quick embrace of free markets after the fall of communism, a quarter century later the region is not yet a player in the global economy. The job of integrating CEE fully into the club of highly developed and prosperous nations is, at best, half-done.

### **Needed: Broader Engagement of Managers, Entrepreneurs, and Leaders**

There is no doubt that the region is full of possibilities. It possesses talent, well-educated technologists, and individuals with creativity and flair. So what is lacking? Our fundamental answer, reflected in most contributions to this volume, is that CEE's public discourse and action are often overly fixated around governments and political ideologies that underlie them. This focus comes at the expense of a serious reflection on and, even more essentially, collective investment in a robust and competitive private sector.

Today nurturing a competitive private sector cannot be limited to the *laissez faire*-ist "letting business do it." Economies are just too multifaceted, interconnected, and knowledge-intensive. Based on decades of thinking and researching various sources of business success, we know that businesses do not operate in a vacuum. Successful "managers, entrepreneurs, and leaders"—as we called them in the *Introduction*—need to navigate and leverage ever more complex settings, simultaneously at the local, national, regional, and global levels. In order to build organizations, reach global markets, and manage ongoing development of key activities CEE businesses must leverage a host of flexible, but increasingly recognized as effective, decision-making approaches.

Apart from explicit knowledge, creating economic value today also requires certain attitudes.<sup>1</sup> Scholars have studied and identified such perspectives, including a preference for autonomy, an ability to thrive in unknown territories requiring fast



Traditional models of professionalism blend with today's spirit of creativity and entrepreneurship.

learning and adaption, an incessant focus on excellence, and a willingness to commit personally to the task at hand and to an organization's larger mission at the same time. We call this package of skills and attitudes *creative managerial profes-*

*sionalism*, which encompasses both accepted models of professionalism and today's spirit of creativity and entrepreneurialism.<sup>2</sup> This represents a powerful blending of disruptively innovative visions and dreams with disciplined and explicit processes for implementing them.

Competitive economies worldwide explicitly aim to achieve this combination, albeit in their own way. Building strong and vital business sectors can be carried out in many contexts. Underpinning such efforts is a realization that the essential practice of today's creative managerial professionalism can be learned.<sup>3</sup> Capturing the benefits of this blend is not simply a matter of instinct, a certain culture, or visionary leadership. Carefully crafted education and development, at business schools and in firms, are needed.



By contrast, CEE does not only suffer from a dearth of creative managerial professionals; but—compared to other regions—does little to come up with ways to develop such crucial competencies. In effect, CEE may possess good inputs—such as technology, basic education, and location—but does not yet have the means to translate these inputs into high-value outputs.

We want to deliver a fundamental message that places highest priority on moving the center of gravity of CEE's intellectual and decision-making efforts away from grand ideological debates and toward pragmatic foundations of the twenty-first century economic prosperity, which today lie especially in the private sector. This basic change of focus is rooted in creative managerial professionalism. Of course, we hope that this book and its viewpoints reach non-business audiences, especially academics and policymakers. Yet our primary goal is to speak directly to managers, entrepreneurs, and other leaders of businesses operating in CEE. With that in mind, we now offer specific managerial lessons that aspiring creative managerial professionals in CEE can draw from this volume.

### Stay Realistic

A key managerial lesson that emerges is that CEE professional managers and entrepreneurs must comprehend their current situation realistically. A rather somber picture of CEE business environment is portrayed in a number of chapters. Our co-authors point out, in particular, the “modest to moderate” levels of innovation in the region (Chapters 1.2 and 3.2), low levels of economic competitiveness (Chapter 2.1), a dearth of financing opportunities (Chapter 1.3), underdevelopment of intellectual property management (Chapter 1.4), prevalence of primitive “me too” strategies leading to market overcrowding (Chapter 1.5), persistent corruption (Chapters 1.6 and 1.9), and overzealous governments distorting market incentives through artless and formalistic interventionism (Chapters 1.7 and 3.2). At a deeper cultural level, we highlight a prevailing hierarchical social structure, which favors blending in over individualism and over outside-the-box thinking (Chapter 1.6) and an acute absence of leadership models (Chapter 3.5).

Because of the ubiquity of such challenges and shortcomings in CEE, we encourage professional managers in the region to apply a hefty dose of cold realism when making decisions. Take, for instance, the perhaps most basic professional choice that a novice manager must make: whether to work in an established corporation or to set up one's own business. Although CEU Business School strongly encourages students to defy the odds and pursue entrepreneurial careers, prudence is also—perhaps unfortunately—a key part of the “defy the odds.” As Horwitch discusses in Chapter 3.2, management literature has long agreed that innovation tends to thrive in clusters of dynamic knowledge-creators and ecosystems. Although usually anchored in supportive climates and cultures, these clusters can also be explicitly developed as a matter of strategy. However, the reality is that such innovation clusters are generally lacking in CEE.

Understanding and accepting reality may constitute a genuine challenge. Managers and entrepreneurs are often, naturally, inclined toward action. Yet that ambition and inclination could lead to trouble. We sometimes witness our school alumni entrepreneurs and others trying to “assume away” the “CEE factor” in business decisions by focusing on market fundamentals, such as the size of consumer base or relative weakness of competition. That approach can be hazardous because a seemingly attractive market niche may in fact be much less attractive once the quality of the relevant business setting is properly taken into account.

A product or service one seeks to deliver may be needed by customers; but what about access to financing? Can one overcome ultraconservative or even corrupt local bankers and obtain funds at sufficient levels and at reasonable cost? As Turner points out in Chapter 1.2, having a sound business plan is frequently not sufficient to secure financing. Likewise, as Kisilowski discusses in Chapter 3.3, it should not be assumed that local bureaucrats and politicians think in pro-business terms. Is there any reason to believe that securing all necessary permits will be successful, especially without personal connections? What is the risk to an emerging business that it will become target of “raids” of local bureaucrats demanding ever-higher bribes? A healthy dose of the so-called “non-market strategies” is required at times in our region.<sup>4</sup>

Corporate executives can, like entrepreneurs, fall prey to an irrational exuberance that overlooks inherent and potentially dangerous limitations within the CEE business setting. A manager of a local service center may have understandable ambitions to introduce increasingly sophisticated functions. But does sufficient local talent exist to support such functions? Likewise, an executive may be naturally inclined to pursue growth when market fundamentals allow it. But as a business grows larger and more profitable, it may increasingly become a target of corrupt, incompetent, or xenophobic governmental officials. A manager may also assume that local communities would support businesses that provide jobs and economic opportunities. But, as case studies analyzed by Torsello in Chapter 3.4 demonstrate, post-socialist societies continue to view businesspeople with suspicion and as potentially corrupt. Political actors can then use this sentiment to shape public discourse to the businessperson’s disadvantage. If seemingly effective available courses of managerial action are actually value destroying, keeping below the radar screen and even limiting growth becomes a legitimate business strategy.<sup>5</sup>

Informed appreciation of contextual challenges may lead to substituting the unrealistic opportunities with the realistic ones. An aspiring entrepreneur may, for instance, consider re-energizing a family business, hitherto run by relatives. This choice might be carried out instead of developing a new business from scratch that could be seen as a possibly more exciting opportunity but would require unattainable levels of financing. A unit manager may pursue a gradual process of in-house investment based on skills of existing employees instead of searching for unavailable better and more sophisticated talent on the outside.



### Create a New Local Culture of Professionalism

Scholars in the field of economic sociology have argued that the way organizations function is often a reflection of the societies in which these organizations are embedded. This blending-in attitude is referred to as “institutional isomorphism.”<sup>6</sup> The relative paucity of innovative, exciting organizations in CEE could possibly suggest that such isomorphism is indeed in play in this region.

But is this phenomenon as pervasive and deterministic as some economic sociologists have claimed, especially at a time when different cultures interact, communicate, and collaborate? An important attribute of creative managerial professionals is their ability to learn and then overcome counter-productive and constraining aspects of traditional local cultures through smart acquired reliance on global standards and practices. Implementing creative managerial professionalism can then act as an antidote against local cultural determinism. CEE managers are urged to leverage this now accessible cosmopolitan and competitive power and embark in a deliberate strategy of creating and expanding pockets of such boundary-spanning behavior at all levels.

Knowledge of a special dual kind is needed in such an effort. It must be informed by both deep understanding of global professional standards and values and by tacit and grounded local familiarity. This blended approach can lead to a wide array of intriguing and novel insights. Take Buzady’s Absorption-based Model of Leadership, discussed in Chapter 3.5. On the one hand, it is founded on deep appreciation of a regional reality: a prevalence of “fast trackers”—that is managers who rose too rapidly in corporate hierarchies during the wayward early days of the free-market transition. On the other hand, Buzady applies cutting-edge findings of organizational science to help both the fast trackers and professionals who work with (or under) them. Buzady’s analysis

shows how an insightful synthesis of global standards and local knowledge can help build organizations that will effectively counter a culture of ineffectiveness that is still too prevalent in the region.

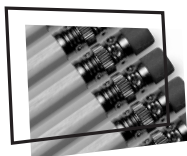
More comprehensive insights in this regard emerge when we juxtapose a regional status quo discussed in Part I of this volume with global trends and new ways of thinking covered in Parts II and III. Compare, for instance, Akbar and Vujic's characterization of an excessively hierarchical and collectivist CEE culture in Chapter 1.6 with Koles's discussion of the generation of "digitally educated workers" in Chapter 2.7. An obvious conclusion that emerges after reading the two chapters is that CEE organizations that continue replicating regional social hierarchies will become increasingly out of sync with the expectations of the millennials—a group that increasingly dominates the character of the workforce and markets. Of course, such a neglect or lag in CEE may constitute now an opportunity for a new fast first mover. A sophisticated manager may reap advantages from a flatter organization, which could position a firm as a uniquely attractive workplace and thereby allow the firm to tap new latent markets.

In a similar vein, Kisilowski's discussion (in Chapter 3.3) of the overly formalistic CEE courts and other administrative agencies can be read in conjunction with Sganga's call for "legal astuteness" (expressed in the context of intellectual property rights in Chapter 1.4). If a potential legal controversy will land on a desk of a governmental official with little business understanding, clarifying governance and ownership issues up front to avoid such controversies becomes particularly important. To be sure, the collectivist culture that Akbar and Vujic analyze in Chapter 1.6 frowns on excessive lawyering in CEE. Entrepreneurs from the region often find it awkward and even demotivating to insist on detailed legal agreements when starting a business with friends or family. Yet, going against such inclinations, starting a business under solid legal scaffolding from the beginning reflects best practice of creative managerial professionalism.

By the same token, it is useful to put in context the heavy-handed approach to achieve desirable social goals at the expense of businesses by some CEE governments (as discussed by Hardi in Chapter 1.7). According to Mulloth (Chapter 2.6), around the world the appetite for tackling social challenges through entrepreneurial, as opposed to bureaucratic, means is palpable and spreading. As CEE societies become more affluent, their middle and upper classes grow more socially and environmentally conscious. However, they also become increasingly disillusioned about government failure to deliver satisfactory levels of effectiveness and efficiency. The rapid growth in CEE of socially entrepreneurial organizations, such as Ashoka, NESsT, DemNet, and the Kairos Society,<sup>7</sup> has profound implications and opens up exciting opportunities for businesses and for creative managerial professionals generally. Integrity rises in importance and acts as a counter-point to pervasive corruption that still haunts our region. Businesses that take integrity seriously will be in a stronger position to benefit from certain shifting expectations taking place.

The ascent of the shale gas industry in Poland, discussed by LaBelle in Chapter 2.5, represents yet another example of using sophisticated understanding of global trends to improve competitive positioning in an imperfect CEE business setting. Here, the effort is not to build an organizational counter-culture or to anticipate value change, but rather to employ deeply engrained attitudes—such as geopolitical anxieties shared by many Poles—to nudge CEE markets closer toward supporting a new industry in the region and incidentally supplant a higher-carbon fossil fuel, coal, with a lower-carbon fossil fuel, shale gas.

The approach highlighted here—establishing high professional standards



Establish professional standards—even if a business context remains largely unprofessional.

where possible even if a broader business context remains unprofessional in significant ways—can be applied to other spheres not specifically discussed in this book. An organization may benefit, for instance, if a manager strives

vigorously toward creating inclusive, harassment-free settings for women, LGBT, or religious minority employees. An organization that is uncharacteristically (for CEE) open and diverse may become particularly attractive for top-level creative talent. Indeed, a clear stance on these issues may trigger a natural self-selection of highly productive employees, encouraging those who are more open-minded and forward-looking.<sup>8</sup>

### Transcend Borders

Despite the impact of globalization and technological innovation, national borders and national character remain pivotal factors in international business strategy.<sup>9</sup> This is certainly the case for CEE, as discussed in Chapter 2.9. In basic terms, like GDP or demography, the region comprises mostly rather small markets. Bögel in Chapter 1.2 and Findrik in Chapter 2.1 add to this picture the somber realization that CEE markets are unlikely to exhibit rapid economic development and grow substantially in the near future.

The case study featured in Chapter 1.5 by Mayer offers a cautionary tale on what may happen when companies focus too much on a single small and stagnant market like Hungary. Overcrowding and massive losses can occur.

That is why looking beyond national borders and being open to immediate expansion beyond one's home turf are essential qualities for a CEE professional manager to acquire. In large economies, like the United States or Japan, a small or even medium-size business can initially serve solely domestic markets. However, this is likely impossible in the fragmented CEE. In countries like Hungary or Croatia, entrepreneurs must increasingly be born global and think about international expansion and organization building practically from the moment they set up their businesses. Executives working in larger, corporate settings must also be used to exploiting competencies, interdependencies, and relationships with sister branches in other countries. Leveraging diversity

and transnational teams are significant capabilities to develop for a professional CEE manager.

How to develop this level of comfort in looking beyond the borders of one's home country? As mentioned before, professionalism is a mix of attitudes and skills. As far as the attitudes are concerned, the Open Society values that our University upholds—including openness to diversity, rejection of dogmas, and a taste for critical thinking—are essential steps. For a professional CEE manager and entrepreneur, the Open Society values are smart foundations for a business ready for the global expansion. In terms of skills, managers should understand major economic forces that are at play in key foreign markets of interest. A number of contributions to this volume can help those in business gain such understanding. Bögel in Chapter 1.2 offers insights on a changing “geography of innovation.” Findrik in Chapter 2.1 presents a complementary map of economic competitiveness. Many of the themes raised by both authors are further explored by Horwitch in Chapter 3.2, which addresses how effective different nations are in applying specific lessons emerging from cutting-edge thinking on strategy and innovation.

The general mapping provided by Bögel, Findrik, and Horwitch is supplemented by discussion of three regions of particular interest to CEE managers. Marer in Chapter 3.2 portrays Western Europe as a region affected by a set of deep, intertwined crises. The analysis makes it clear that these crises are unlikely to loosen their grip over the “old Europe” anytime soon. Shattuck in Chapter 3.4 argues for increased American re-engagement with Europe. Shattuck's discussion places emphasis on commonality of values between CEE and the West. His presentation of democracy and human rights may—at first glance—appear somewhat distant to businesspeople, but it has serious business implications. Western Europe and the United States represent huge markets where property rights are protected and contracts enforceable. Their political systems are relatively transparent and non-corrupt. Such features significantly reduce business risks. Therefore, Western markets may be especially important for small CEE businesses, which already often operate in uncertain and volatile business settings.

Yet the very fact that Shattuck finds it necessary even to call for a deepening of U.S. economic ties means that the value of Europe, and especially of CEE, is not universally accepted in America (or in some other parts of the world for that matter). If that is the case, then looking East as well as West may make sense for a CEE entrepreneur. Lacourbe, in Chapter 3.3, sees China as most eager to engage with our region through various new channels. With new physical infrastructure, complementary markets, and financial resources, China is encouraging CEE to truly exploit its crossroads location.

Of course, playing the China card is fraught with risk, as reflected by the brief outline of “China's Key Strategic Objectives” provided by Lacourbe in Chapter 3.3. China is by no measure an Open Society based on the Western values that



Shattuck highlighted. But with pervasive corruption and unpredictable regulatory policies in their own region, CEE managers may be more effective in navigating China and similar not-so-transparent economies than their counterparts in the West. Creative professionalism can also build on tacit knowledge found closer to home.

### **Foment Fundamental and Systemic Change**

So far, we have repeatedly emphasized the need for realism, objectivity, and managing risks in assessing current and future CEE business settings, all within the context of noting an unprecedented role of business in the region in the coming decades.

However, an overwhelming lesson from our work is that incrementalism is not enough. Realism, local innovation, risk management, and looking beyond home markets are not sufficient for a CEE version of creative managerial professionalism. CEE managers and entrepreneurs should seek opportunities for pushing for broader systemic change.

Indeed, having a robust creative managerial professionalism in place would constitute one of the most effective triggers of social change. There are several reasons for this. Managers and entrepreneurs are less inclined than politicians to rely on wishful thinking. They are also more appreciative of the high-priority requirement to focus on implementation, even at the early stages of problem definition. They have close affinities with counterparts outside of CEE and, thus, can quickly learn about ideas and experiences of other economies and regions. And they all have a vital stake in CEE continuing on a path of socio-economic modernization.

How to become such an engaged creative managerial professional? Understanding and then applying state-of-the-art knowledge and ideas are important first steps here. They provide a point of view and confidence for fitting specific proposals into a broader narrative and action. For example, Horwitch's discussion in Chapter 3.2 makes it clear that political leaders of nations, regions, or cities can benefit from the vast body of readily available thinking on how to improve economic innovativeness. Similarly, Kisilowski's recommendations for encouraging fact-based economic policymaking—spelled out in Chapter 3.3—mirror broader developments already prevalent in many developed countries and supported by such international institutions as the OECD.<sup>10</sup> There is also renewed interest on both sides of the Atlantic in the importance of civil society and stakeholder engagement in policymaking, which is explored by Torsello in Chapter 3.4. One reason for this is due to some influential studies that have linked civic engagement with economic development.<sup>11</sup> The notions of cognitive bias and predictive irrationality, discussed by Fogelman in Chapter 3.6, are also increasingly present in global policy debates, especially in the wake of the 2008 global financial crisis. Sooner or later, these ideas will trickle down to national politicians or senior civil servants. So being versed in such forward-thinking

ideas ultimately tends to make arguments of managers and entrepreneurs more creditable.

To be sure, it takes not only knowledge but also attitude to exploit effectively opportunities for systemic change. Professional CEE managers must be active in their communities. An engagement in a local chamber of commerce or a professional association may be a good start. In addition, a businessperson may consider making (legal) political contributions or supporting nongovernmental organizations that advocate causes worthy of support. By becoming socially involved and acting with integrity, a senior manager sets an example likely to be followed by subordinates, colleagues, and even competitors, thereby multiplying the social impact of one's initial engagement. Being visible and contributing may trigger a virtuous circle in which gaining an initial legitimacy to demand professionalism and respect from governmental and nongovernmental stakeholders will lead to further far-reaching beneficial changes, all of which gather greater force over time. Slowly but surely the dysfunctional system may begin to change.

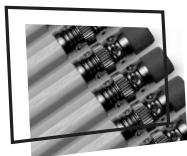
### **Time to Grow Up**

As is evident from the preceding discussion, creative managerial professionalism—practiced by either a corporate executive or an entrepreneur—requires high levels of intellectual and attitudinal sophistication. This is true not only in CEE but everywhere. Around the world, the twin forces of globalization and digitalization are creating unprecedented opportunities, but also introducing complexities and risks. These complexities, discussed throughout this volume, exert a profound impact on the careers of individual managers and entrepreneurs. Even a couple decades ago, one could start a business, grow it organically, and learn on the go. Today, an entrepreneur is instantly required to interact with bankers or venture capitalists (see Chapter 1.3), think about managing intellectual property (see Chapter 1.4), navigate a maze of regulations (see Chapter 3.3), consider social expectations regarding businesses' social and environmental responsibility (see Chapters 1.7 and 2.5), and find one's place in the increasingly global supply chain (see Chapter 2.3). The successful modern entrepreneur should, in short, reflect best practices of creative and global managerial professionalism.

CEE managers and entrepreneurs must now step up to the plate, hone their professional skills and attitudes and use their drive and ambition to push the region forward. Indeed, if the economic stagnation that currently affects the region continues, CEE's best and brightest will increasingly "vote with their feet" and leave. At CEU Business School, we are always happy to see our students succeed anywhere in the world, but we admit to being increasingly concerned when top students feel compelled to leave their home countries in order to seek opportunities elsewhere. We are equally frustrated to see how many of our graduates must put up with less-than-challenging managerial roles in back offices and service centers, because they are not afforded the opportunity to use their talent and education in more sophisticated, high-value, and high-impact business activities.



Granted, this is just a stage in a longer story of this unique and fascinating part of the world that we hold dear. CEE is a free market in its twenties, and the



Twenties is the time to wander. But it is also the time to start acting like an adult.

twenties is the time to wander around the world and experiment with life and work. Yet that luxury of the extended youth is over. It is time to start thinking and acting like an adult.

## NOTES

- <sup>1</sup> See, e.g., Thomas H. Davenport, *Thinking for a Living* (Harvard Business School Press, 2005).
- <sup>2</sup> Business schools, including CEU Business School, increasingly require entrepreneurship as part of an MBA education. On the pressing need for more entrepreneurship education in Europe, not just in CEE, see Karen Wilson, "Entrepreneurship and Education in Europe," in *Entrepreneurship and Higher Education*, edited by Jonathan Potter (OECD, 2008); and Caroline Rizza and Celeste Amorim, *Directions in Entrepreneurship Education in Europe*, paper presented at the twentieth Meeting of the Economics of Education Association, 12 May 2011.
- <sup>3</sup> Peter F. Drucker, "The New Productivity Challenge," *Harvard Business Review*, vol. 69 (1991), 70; Joan Magretta and Nan Stone, *What Management Is: How It Works and Why It's Everyone's Business* (Free Press, 2002); Ikujiro Nonaka and Hirotaka Takeuchi, *The Knowledge-Creating Company: How Japanese Companies Create the Dynamics of Innovation* (Oxford University Press, 1995).
- <sup>4</sup> Yusuf H. Akbar and Maciej Kisilowski, "Nonmarket Strategy in Eastern Europe and Central Asia," in *Routledge Companion to Nonmarket Strategy*, edited by Thomas C. Lawton and Tazeeb Rajwani (Routledge, 2014).
- <sup>5</sup> This point is largely based on several conversations with top managers in CEE countries and with many of our EMBA alumni over the years.
- <sup>6</sup> Paul J. DiMaggio and Walter Powell, "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields," *American Sociological Review*, vol. 48 (1983), 147–160.
- <sup>7</sup> CEU Business School has partnered with, and/or hosted in our incubator, CEU InnovationsLab, these socially entrepreneurial organizations.
- <sup>8</sup> For the general business case for tolerance and openness, see Richard Florida, *The Rise of the Creative Class* (Basic Books, 2004).
- <sup>9</sup> Pankaj Ghemawat, *Redefining Global Strategy: Crossing Borders in a World Where Differences Still Matter* (Harvard Business School Press, 2007).
- <sup>10</sup> Available at <http://www.oecd.org/gov/regulatory-policy/betterregulationineurope-theeu15project.htm> (accessed 15 April 2014).
- <sup>11</sup> Robert Putnam, *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton University Press, 1994).



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As an editor, I want to thank my co-authors, who have shown commitment and team spirit that made this endeavor possible. György Bögel and Peter Hardi deserve particular credit for initiating the discussion within our faculty that ultimately led to the creation of this volume. Maria Findrik, Paul Lacourbe, and Paul Marer offered valued help at some key junctures of this project. My heartfelt thanks go also to Mel Horwitch, who was the source of intellectual support and inspiration for me throughout this process.

Yet the deepest gratitude, and here I surely express the sentiment of all my colleagues, is owed to the founder of our institution, George Soros—both for his thoughtful foreword that set the tone for our story and for his extraordinary generosity in supporting CEU Business School and the values and aspirations that it represents.

Maciej Kisilowski

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**George Soros**, with a group of other philanthropists, founded CEU Business School in 1988. He founded CEU in 1991 and the two merged in 2002. Soros serves on the CEU Board as honorary chairman. He is chair of the Soros Fund Management and the Open Society Foundations, the latter organization promotes the values of open society, human rights, and transparency in more than 100 countries. Born in Budapest in 1930, he survived Nazi occupation and fled communist-dominated Hungary in 1947 for England. He graduated from the London School of Economics. He settled in the United States, where he accumulated a large fortune through his international investment fund. He authored over a dozen books, including *The Tragedy of the European Union: Disintegration or Revival?* (PublicAffairs, 2014). His articles and essays on politics, society, and economics regularly appear in major newspapers and magazines.

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